Recent Developments Affecting Real Estate and Pass Through Entities

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I. LEGISLATIVE DEVELOPMENTS

A. The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011. The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 (the “Comprehensive 1099 Taxpayer Protection and Repayment Act”), Pub. L. No. 112-9, retroactively repealed the information reporting requirements for rental property expense payments enacted in the 2010 Small Business Act and repealed the expansion of information reporting requirements to payments made to corporations.

1. Repeal of Information Reporting for Rental Property Expense Payments. Under the 2010 Small Business Act, as of January 1, 2011 rental income recipients making payments of $600 or more to a service provider (such as a painter, plumber, electrician or accountant) in the course of earning rental income had to provide an information return (typically, IRS Form 1099-MISC) to the Service and to the service provider. The 1099 Taxpayer Protection and Repayment Act repealed this provision, effective for payments made after December 31, 2010.

2. Repeal of Expansion of Information Reporting Requirements for Certain Payments. Under the Health Care Act, taxpayers engaged in a trade or business would have had to file an information return (presumably an IRS Form 1099-MISC) for payments (including gross proceeds) made after December 31, 2011 in consideration for property or services to any payee (including a corporate payee that is not a tax-exempt corporation), if such payee were paid in the aggregate more than $600 in a year by the payor. In other words, the Health Care Act expanded both the types of payments that needed to be reported (i.e., payments for goods) and the types of payees which needed to be included for reporting purposes (i.e., corporations). The 1099 Taxpayer Protection and Repayment Act repealed this provision.


1. Retroactive Reinstatement of the Estate and GST Tax. The Economic Growth and Tax Relief Reconciliation Act of 2010 (“EGTRA”), Pub. L. No. 107-16, repealed the estate tax for decedents dying in 2010 and for GSTs made in 2010. TRA 2010 retroactively reinstated the estate and GST tax for 2010 (as an alternative to the law in effect in 2010, with no estate tax or GST tax and a “modified” step up in basis) and provided the tax rate and exemption amounts for 2011 and 2012.

a. For a decedent who died in 2010, TRA 2010 provides a $5 million estate and GST tax exemption (effective as of January 1, 2010), with a corresponding step-up in basis equal to the fair market value as of the date of death. The top estate tax rate is 35%. However, the executor of an estate of a decedent who died in 2010 can elect out of the estate tax and instead embrace the modified carry-over basis rules of Section 1022.
b. For 2010, TRA 2010 provides a $1 million gift tax exemption with a top tax rate of 35%. For 2011 and 2012, it provides a $5 million unified estate tax and gift tax exemption with a top tax rate of 35%. (The exemption amount will be indexed for inflation, in increments of $10,000, beginning in 2012.) Furthermore, for 2011 and 2012, TRA 2010 provides “portability”, whereby the executor of a deceased spouse’s estate may transfer any unused estate tax exemption to the spouse without using a trust; caveat: this portability can be used only once.

c. With respect to the GST tax, TRA 2010 provides a $5 million exemption (effective as of January 1, 2010). For 2010, the GST tax rate is 0% and for 2011 and 2012, the top tax rate is 35%. Although the GST exemption can be allocated to applicable transfers in 2010, for certain GST direct skip trusts, it might make sense to elect out of the automatic allocation of the GST exemption on the 2010 Federal gift tax return.

d. The due date for any estate or generation-skipping tax return for the estate of a decedent dying after December 31, 2009, or a generation-skipping transfer made after such date, and before December 17, 2010 (the date of enactment of TRA 2010) was extended to nine months after the date of enactment.

2. Extension of Reduced Tax Rates. EGTRA reduced the top four marginal income tax rates for individuals and trusts and estates to 25%, 28%, 33% and 35%. This provision was due to expire after December 31, 2010. TRA 2010 provides that the EGTRA tax rates will continue for two additional years (i.e., until January 1, 2013). In addition, TRA 2010 extends for two years the rates on long-term capital gain income set forth in the 2003 Jobs and Growth Act, Pub. L. No. 108-27, as amended by the 2005 Tax Increase Prevention Act, Pub. L. No. 109-222. As a result, until January 1, 2013, the maximum long-term capital gains tax rate (and, as a concomitant, rates on dividends from C corporations) are 0% (for individuals in the 10% and 15% tax bracket) and 15% (for all other individuals).

3. Payroll Tax Reduction. Under the Federal Insurance Contributions Act (“FICA”), two taxes are imposed on employers and employees – an old-age, survivors and disability insurance tax (“OASDI”) and a Medicare tax. For 2011, the OASDI tax is computed on the first $106,800 of the employee’s wages. TRA 2010 reduces the employee OASDI tax rate from 6.2% to 4.2% for 2011. A similar rate reduction also applies to self-employed individuals.

a. This payroll tax reduction replaces the Making Work Pay tax credit, which provided a $400-per-worker tax credit.

b. However, the Making Work Pay tax credit was phased out for workers earning more than $75,000 ($150,000 per couple). The payroll tax deduction does not have a phase out provision.

4. AMT Patch for 2010 and 2011. TRA 2010 extends the 2009 AMT patch for two years, with a slight increase. For 2010, the AMT exemption amounts are increased to $72,450 for married individuals filing a joint return and surviving spouses; $47,450 for unmarried individuals other than surviving spouses; and $36,225 for married individuals filing a separate return. For 2011, the AMT exemption amounts are increased to $74,450 for married
individuals filing a joint return and surviving spouses; $48,450 for unmarried individuals other than surviving spouses; and $37,225 for married individuals filing a separate return.

5. **Extension of Bonus Depreciation and Increase in Percentage.** Under prior law, taxpayers were entitled to a bonus depreciation deduction equal to 50% of the basis of certain eligible property.

   a. TRA 2010 extends the placed-in-service date requirement of eligible property for two years until December 31, 2012. In addition, the timely acquisition rules were also extended for two years, so that, in general, the property can be acquired by the taxpayer either after December 31, 2007 and before January 1, 2013 (if no written binding contract for the acquisition was in effect before January 1, 2008) or under a written binding contract entered into after December 31, 2007 and before January 1, 2013.

   b. For property acquired by the taxpayer after September 8, 2010 and before January 1, 2012 and which, in general, is placed in service before January 1, 2012, TRA 2010 increases the bonus depreciation percentage to 100 percent.

6. **Additional Extension of Time to Elect the Acceleration of AMT and R&D Credits.**

   a. The Housing Assistance Tax Act of 2008, Pub. L. No. 110-289, permitted corporations to make an election, for the first tax year of the taxpayer ending after March 31, 2008, which would accelerate the use of the alternative minimum tax and research and development credit carryovers, in lieu of the bonus depreciation tax benefit included in the Economic Stimulus Act of 2008. The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, provided that, if the taxpayer did not make the election after March 31, 2008, the taxpayer could make the election for its first tax year ending after December 31, 2008 and each later year for certain “extension property”.

   b. To take into account the extension of the placed-in-service deadline for qualified property eligible for bonus depreciation, TRA 2010 provides a “round 2 extension” to cover property placed in service after December 31, 2010 and before January 1, 2013. For round 2 extension property, bonus depreciation cannot be exchanged for any research credits from tax years beginning before January 1, 2006.

      (1) If a taxpayer previously elected to forgo bonus depreciation for the acceleration of certain credits, it can elect to decline to have the election apply to round 2 extension property. Otherwise, a separate computation must be made for round 2 extension property.

      (2) If a taxpayer did not make a previous election, it can make the election for its first taxable year ending after December 31, 2010. This election will only be applicable to eligible round 2 extension property.

7. **Increase in Section 179 Expensing for 2012.** Under prior law, the maximum amount of the deduction under Section 179 for 2012 was $25,000, which was phased out for each dollar of qualifying property placed in service during the taxable year in excess of
$200,000. For 2012, TRA 2010 increases the maximum amount of the deduction to $125,000 and the phase-out threshold to $500,000. This amount, however, is significantly lower than the Section 179 deduction amount for 2010 and 2011, during which the maximum amount of the deduction is $500,000 and the phase-out threshold is $2 million. (See Part I.C.1.)

8. Extension of Increase in Gain Exclusion for Qualified Small Business Stock. The 2010 Small Business Act provided that taxpayers, other than corporations, were not subject to regular or AMT tax on the gain from the sale or exchange of qualified small business stock held for more than 5 years, if such stock was acquired after September 27, 2010 and before January 1, 2011. (See Part I.C.3.) TRA 2010 extends the exclusion until January 1, 2012.

9. Extension of Fifteen-Year Straight-Line Cost Recovery for Certain Real Property. Under prior law, qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property were all depreciated on the straight-line method over a 15-year recovery period. To qualify for such treatment, the property needed to be placed in service before January 1, 2010. TRA 2010 extends the placed-in-service date for two years (i.e., before January 1, 2012).

10. Extension of Election to Expense Environmental Remediation Expenditures. TRA 2010 extends the provision permitting taxpayers to expense certain qualified environmental remediation expenditures to include expenditures paid or incurred before January 1, 2012. This extension is retroactive for expenditures paid or incurred during 2010. As a result, for certain fiscal year taxpayers who have already filed their Federal tax returns for 2010, they should consider filing an amended return to capture any amounts that they may have capitalized but, under current law, would be able to deduct.

11. Extension of Interest Deduction for Mortgage Insurance Premiums. TRA 2010 extends the provision permitting taxpayers to take an itemized deduction for certain mortgage insurance premiums, such as private mortgage insurance or mortgage insurance provided by the Department of Veteran Affairs, for one year. As a result, in general, taxpayers can take a deduction for qualified mortgage premiums paid or accrued before January 1, 2012.

12. IRA Charitable Rollover. TRA 2010 allows a taxpayer who is 70½ or older to make charitable distributions from his or her IRA of up to $100,000 per year in 2010 and 2011 without incurring income tax on the distribution or obtaining a charitable deduction. The individual may make the charitable distributions in January of 2011 and treat such distributions as made in 2010.
year in excess of $800,000. For 2010 and 2011, the 2010 Small Business Act increases the maximum amount of the deduction to $500,000 and the phase-out threshold to $2 million.

2. **Section 179 Property Includes Qualified Real Property for 2010 and 2011.** For 2010 and 2011, the 2010 Small Business Act temporarily expands the definition of “Section 179 property” to include “qualified real property”. Qualified real property includes certain qualified leasehold improvements described in Section 168(e)(6), certain qualified restaurant property described in Section 168(e)(7), and certain qualified retail improvement property described in Section 168(e)(8). However, the maximum amount a taxpayer may expense for such Section 179 property is limited to $250,000. In addition, no amount attributable to such qualified real property can be carried over past 2011.

3. **Increase in Gain Exclusion for Qualified Small Business Stock.** The 2010 Small Business Act provides that taxpayers, other than corporations, are not subject to regular or AMT tax on the gain from the sale or exchange of qualified small business stock held for more than 5 years, if such stock was acquired after September 27, 2010 and before January 1, 2011.

4. **Five-Year Carryback of General Business Credits.** Prior to the enactment of the 2010 Small Business Act, business credits were generally entitled to be carried back one year and carried forward 20 years. However, under the 2010 Small Business Act, for the first taxable year of an “eligible small business” beginning in 2010, unused but eligible business credits can be carried back five years.
   a. An eligible small business is a corporation, the stock of which is not publicly traded, a partnership or a sole proprietorship, if the average annual gross receipts of such entity for the 3-taxable year period preceding such taxable year do not exceed $50 million.
   b. In order for a partner or shareholder of an eligible small business to take advantage of this provision, the partner or shareholder must also satisfy the gross receipts test for the taxable year in which such credits are treated as current year business credits.
   c. Eligible small businesses can use the credits to offset both regular and AMT tax liabilities.

5. **Shortened Built-in Gain Recognition Period for S Corporations.** For tax years beginning in 2011, the 2010 Small Business Act reduces the built-in gain recognition period to five years from the first day of the first taxable year for which the corporation was an S corporation. In general, the recognition period is ten years; however, for 2009 and 2010 the recognition period is seven years.

6. **Extension of Bonus Depreciation.** The Economic Stimulus Act of 2008 contained a bonus depreciation deduction equal to 50 percent of the basis of certain eligible property. The American Recovery and Reinvestment Act of 2009 extended the placed-in-service date requirement and timely acquisition rules by one year until December 31, 2009. The 2010 Small Business Act further extended the placed-in-service date requirement by one year until December 31, 2010. In addition, the timely acquisition rules were also extended one year, so the property can be acquired by the taxpayer either after December 31, 2007 and before January 1, 2011 (if no written binding contract for the acquisition was in effect before January 1, 2008) or
under a written binding contract entered into after December 31, 2007 and before January 1, 2011.

7. **Extension of Time to Elect the Acceleration of AMT and R&D Credits.** The Housing Assistance Tax Act of 2008 permitted corporations to make an election, for the first tax year of the taxpayer ending after March 31, 2008, which would accelerate the use of the alternative minimum tax and research and development credit carryovers, in lieu of the bonus depreciation tax benefit included in the Economic Stimulus Act of 2008. The American Recovery and Reinvestment Act of 2009 provided that, if the taxpayer did not make the election after March 31, 2008, the taxpayer could make the election for its first tax year ending after December 31, 2008 and each later year for certain “extension property”. In general, “extension property” was eligible qualified property placed-in-service after December 31, 2008 and before January 1, 2010. Under the 2010 Small Business Act, the placed in service date of extension property was extended for an additional year. As a result, generally speaking, eligible extension property must be placed in service after December 31, 2008 and before January 1, 2011.

8. **Disregard of Bonus Depreciation in Computing Percentage of Completion.** In general, the taxable income arising from a long-term contract is determined under the percentage of completion method set forth in Section 460. Under this method, the percentage of completion is determined by comparing costs allocated to the long-term contract and incurred before the end of the taxable year with the estimated total costs. Depreciation is among the costs allocated to the contract. For purposes of determining the percentage of completion method, the 2010 Small Business Act provides that the costs allocated to a contract are determined as if the bonus depreciation provisions under Section 168(k) had not been enacted.

9. **Increase in Deduction for Start-up Expenditures.** Under Section 195, a taxpayer can elect to deduct up to $5,000 of start-up expenditures in the year its active trade or business begins. However, the $5,000 amount is reduced by the amount by which the cumulative cost of start-up expenditures exceeds $50,000. For taxable years beginning in 2010, the 2010 Small Business Act increases this deduction to $10,000 and increases the phase-out threshold to $60,000.

10. **Increase in Penalty for Failure to File Information Returns.** In addition to changing the taxpayers who are subject to information reporting requirements, the 2010 Small Business Act doubled the penalty for failure to file information returns required to be filed after December 31, 2010. In general, the penalty is equal to $100 per return.

D. **The Homebuyer Assistance Improvement Act of 2010.** The Homebuyer Assistance Improvement Act of 2010 (the “Homebuyer Assistance Act”), Pub. L. No. 111-198, was signed into law on July 2, 2010. It was designed to provide relief for first-time home buyers and certain long-term residents of the same principal residence who failed to meet the closing date deadlines in Section 36(h).

1. **Homebuyer Credit Closing Deadline Extended.** Prior to the enactment of the Homebuyer Assistance Act, Section 36(h)(2), as amended by The Worker, Homeownership, and Business Assistance Act of 2009, provided that a qualified first-time homebuyer or long-
term resident was entitled to a homebuyer credit if a written binding contract was entered into before May 1, 2010 and the purchase closed before July 1, 2010.

a. The Homebuyer Assistance Act extended the purchase closing date by three months. Qualified taxpayers will be entitled to claim the homebuyer credit so long as the purchase of their residence closes before October 1, 2010.

b. The Homebuyer Assistance Act did not extend the deadline for entering into the contract.

c. This provision is effective for residences purchased after June 30, 2010.

2. Bad Check Penalty Provision Broadened. To help pay for the taxpayer relief provided in the Homebuyer Assistance Act, the Act also broadened the “bad check” penalty provision in Section 6657. Section 6657 previously provided a penalty to persons who tendered a check or money order that was not duly paid on presentation. The Homebuyer Assistance Act broadened the instruments subject to Section 6657 by providing that the penalty applies to the tendering of any instrument in payment, by commercially acceptable means. Consequently, the Section 6657 penalty now covers electronic payments.

a. The amount of the penalty did not change. Generally, it is equal to 2% of the amount of the instrument.

b. This provision is effective for instruments tendered after July 2, 2010 (the date of enactment).

E. The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010. The Patient Protection and Affordable Care Act (the “Health Care Act”), Pub. L. No. 111-148, and the Health Care and Education Reconciliation Act of 2010 (the “Reconciliation Act”), Pub. L. No. 111-152, were signed into law on March 23, 2010 and March 30, 2010, respectively. Together, these two Acts are designed to overhaul the U.S. health care system. To pay for this initiative, several tax provisions were enacted which impact real estate endeavors.

1. Tax on Unearned Income. Beginning in 2013, the Medicare tax will be imposed on “unearned income”. Unearned income includes the typical investment income items, such as taxable capital gains, dividends, royalties, and interest income. It also includes net rental income (rental income reduced by any allowable deductions), taxable gains on the disposition of rental real estate property, and income earned on the investment of working capital. It will not apply if the income is not considered from a “passive activity” under Section 469.

a. For individuals, the tax applies to joint filers with a modified adjusted gross income (“AGI”) of at least $250,000 and to single filers with at least a $200,000 modified AGI. The tax applies only to income that exceeds the $250,000 (or $200,000) threshold. The tax rate is 3.8%.
b. For an estate or trust, the surtax is 3.8% of the lesser of:

(1) Undistributed net investment income, or

(2) The excess of AGI over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

c. The tax does not apply to a nonresident alien, a trust all the unexpired interests in which are devoted to charitable purposes, a trust that is exempt from tax under Section 501, or a charitable remainder trust exempt from tax under Section 664.

2. Tax on Dispositions of Partnership and S Corporation Interests. Beginning in 2013, “unearned income” subject to the 3.8 percent Medicare investment tax includes income earned on the disposition of an interest in a partnership, limited liability company or S corporation to the extent of the net gain which would be taken into account by the transferor if all property of the entity were sold for fair market value immediately before the disposition of such interest. Similar to the tax on unearned income, there is an exception for a taxpayer who has a non-passive interest in the entity. In computing the amount subject to the tax, a look-through rule applies and the owner of the disposed interest is taxed on his or her share of the passive assets of the entity.

3. Codification of the Economic Substance Doctrine. The Reconciliation Act codified the economic substance doctrine as Section 7701(o).

a. For transactions entered into after March 30, 2010, a transaction will be considered to have “economic substance” only if:

(1) The transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position; and

(2) The taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

b. For underpayments attributable to a transaction lacking “economic substance” entered into after March 30, 2010, a 20 percent accuracy-related penalty (increased to 40 percent if the taxpayer does not adequately disclose the relevant facts affecting the tax treatment in the return) will be imposed. There are no exceptions (including the reasonable cause rules) to the penalty. Consequently, in-house analysis or outside opinions do not protect a taxpayer from imposition of a penalty if it is determined that the transaction lacks economic substance.

II. 2011-2012 PRIORITY GUIDANCE PLAN (ISSUED SEPTEMBER 2, 2011)

A. Corporations and Their Shareholders.

1. Final Regulations under Section 108(i). (Temporary Regulations were issued on August 11, 2010.)
2. Guidance under Section 337(d) related to real estate investment trusts and regulated investment companies.

B. Financial Institutions and Products.


2. Revenue Ruling on the treatment of an interest in a money market fund as a cash item under Section 856(c)(4)(A).

3. Regulations relating to accruals of interest (including discount) on distressed debt.

C. General Tax Issues.

1. Final Regulations under Section 42 on the requirements for a qualified contract. (Proposed Regulations were published June 19, 2007.)

2. Final Regulations under Section 45D on how an entity serving targeted populations meets the requirements to be a qualified active low-income community business. (Proposed Regulations were published September 24, 2008.)

3. Final Regulations under Section 45D that revise and clarify certain rules relating to the recapture of the new markets tax credit. (Proposed Regulations were published August 11, 2008.)

4. Regulations under Sections 108 and 7701 concerning bankruptcy and insolvency rules and disregarded entities. Proposed Regulations were published on April 13, 2011.

5. Revenue Procedure under Section 108(c) on the definition of “secured by real property”.

6. Final Regulations under Section 108(i) for partnerships and S corporations. Temporary and Proposed Regulations were published on August 13, 2010.

7. Regulations under Section 280A regarding deductions for expenses attributable to the business use of homes and rental of vacations homes.

8. Guidance regarding the scope and application of the rescission doctrine.

D. Gifts, Estates and Trusts.

2. Guidance on portability of Unified Credit between spouses under Section 2010(c).

3. Revenue Ruling on whether a grantor’s retention of a power to substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will cause insurance policies held in the trust to be includible in the grantor’s gross estate under Section 2042.

4. Guidance under Section 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.

5. Notice on decanting of trusts under Sections 2501 and 2601.

E. Partnerships.


2. Final Regulations under Section 108(e)(8). (Proposed Regulations were published on October 31, 2008.)

3. Regulations under Section 469(h)(2) concerning limited partners and material participation.

4. Regulations under Section 721 regarding the tax treatment of noncompensatory options and convertible instruments issued by a partnership. (Proposed Regulations were published on January 22, 2003.)

5. Guidance under Section 7704 related to cancellation of indebtedness income.

F. Subchapter S.

1. Guidance under Sections 1362 and 9100 regarding elections of S corporations.

2. Guidance under Section 1367 regarding S corporations and back-to-back loans.

G. Tax Accounting.

1. Revenue Procedure under Section 179(f), as added by the Small Business Jobs Act of 2010, regarding qualified real property.

2. Final Regulations under Section 263(a) regarding the deduction and capitalization of expenditures for tangible assets. (Proposed Regulations were published on March 10, 2008.)
3. Final Regulations under Section 263(a) regarding the deduction and capitalization of expenditures for tangible assets. (Proposed Regulations were published on March 10, 2008.)

4. Guidance under Section 460 regarding home construction contracts. (Proposed Regulations were issued on August 4, 2008.)

5. Revenue Ruling under Section 461 regarding the recurring item exception to the all events test.

H. Tax Administration.

1. Regulations under Section 6166 regarding the furnishing of security in connection with an election to pay the estate tax in installments.

2. Guidance under Sections 7701(o) and 6662(b)(6) regarding codification of the economic substance doctrine by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010. (See Notice 2010-62, 2010-40 I.R.B. 411.)

III. PROPOSED, TEMPORARY AND FINAL REGULATIONS

A. Section 45D (New Markets Tax Credit Non-Real Estate Investments)

1. Overview. The Service has issued Proposed Regulations modifying the new markets tax credit program to facilitate and encourage investments in non-real estate businesses.

2. Reinvestment Requirements.
   
a. Currently, the new markets tax credit program generally requires that a qualified community development entity (a “CDE”) that receives returns on investments (including principal repayments from amortizing loans) re-invest those proceeds into other qualified low-income community investments during the seven-year credit period. This reinvestment requirement makes it difficult for CDEs to provide working capital loans to non-real estate businesses, as these loans are ordinarily considered amortizing loans with a term of five years or less.

b. To help alleviate this issue, the Proposed Regulations would allow a CDE that makes a qualified low-income community investment involving a non-real estate business to invest certain returns of capital from those investments in unrelated certified community development financial institutions (“CDFIs”) that are considered CDEs at various points during the seven-year credit period.

   (1) The Proposed Regulations allow an increasing aggregate amount to be invested in qualified community development financial institutions over the seven-year credit period.
(2) The CDE’s reinvestment of returned capital in qualified CDFIs would satisfy the reinvestment requirements of the new markets tax credit program.

3. **Non-Real Estate Qualified Active Low-Income Community Business.** The Proposed Regulations define a non-real estate qualified active low-income community business as any business whose predominant business activity (measured by more than 50 percent of the business’s gross income) does not include the development (including construction of new facilities and rehabilitation/enhancement of existing facilities), management, or leasing of real estate.

4. **Effective Date.** The Proposed Regulations are effective for taxable years ending on or after the date the Final Regulations are published.

### B. Section 108 (Application of Exclusions to Disregarded Entities)

1. **Overview.** Section 61(a)(12) provides that cancellation of indebtedness income is generally includable in gross income. Section 108 provides a number of exclusions, including an exclusion for cancellation of indebtedness income arising from the discharge of indebtedness in a bankruptcy case or to the extent that the taxpayer is insolvent. Some taxpayers have taken the position that the bankruptcy and insolvency exclusions under Section 108 are applicable if a disregarded entity (i.e., a grantor trust or single-member limited liability company) is bankrupt or insolvent, even if its owner is not. On April 12, 2011, Proposed Regulations were issued explaining the application of Section 108 to disregarded entities.

2. **Application of Section 108 to Disregarded Entities.** The Proposed Regulations provide that, for purposes of applying Sections 108(a)(1)(A) and (B) (the bankruptcy and insolvency exclusion provisions) to discharge of indebtedness income of a grantor trust or a disregarded entity, the “taxpayer” will be the owner of the grantor trust or the disregarded entity. In other words, if the grantor trust or disregarded entity is in bankruptcy proceedings or is insolvent, but the owner of such entity is not, Sections 108(a)(1)(A) and/or (B) will not apply to the discharge of indebtedness income.

3. **Effective Date.** The Proposed Regulations are proposed to apply to discharge of indebtedness income occurring on or after the date the Final Regulations are published.

### C. Section 108(i) (Deferred Discharge of Indebtedness)

1. **Overview.** The American Recovery and Reinvestment Act added Section 108(i), which generally provides for an elective deferral of discharge of indebtedness income realized by a taxpayer from a reacquisition of an applicable debt instrument in 2009 and 2010. The discharge of indebtedness income is included in gross income ratably over a 5-year period beginning in 2014. On August 11, 2010, Temporary Regulations were issued explaining the application of Section 108(i) to C corporations, S corporations and partnerships.

2. **Application of Section 108(i) to C Corporations.** The major concern addressed by the Temporary Regulations for C corporations is the deferral rules under Section 108(i)(5)(D), which accelerates the inclusion of a taxpayer’s remaining deferred discharge of
indebtedness income in certain instances. The Temporary Regulations are intended to preserve the government’s ability to collect the tax liability associated with the deferred discharge of indebtedness income while at the same time narrowly interpreting the statutory acceleration events in order not to require acceleration in circumstances that do not pose collectability concerns.

a. Acceleration on Failure to Maintain Minimum Net Value: In general, under the Temporary Regulations, an electing C corporation is required to accelerate all of its remaining deferred cancellation of indebtedness income if, immediately after an “impairment transaction”, the gross value of the corporation’s assets is less than 110% of the sum of its total liability and the tax (using the highest rate of tax) on the net amount of its deferred items.

(1) Impairment Transactions: “Impairment transactions” are defined as “any transactions, however effected, that impair an electing corporation’s ability to pay the amount of Federal income tax liability on its deferred COD income”. It includes distributions, redemptions, below market sales and incurring additional indebtedness without a corresponding increase in asset value.

(a) For RICs and REITs, any distribution that is treated as a dividend under Section 852 or 857 is not treated as an impairment transaction.

(b) The redemption of a redeemable security by a RIC in the ordinary course of business is not treated as an impairment transaction.

(2) Mitigation Provisions: If the electing C corporation’s value is restored before the due date of the corporation’s return in an amount equal to the lesser of (a) the amount of the value that was removed or (b) the amount by which the sum of its total liability and the tax (using the highest tax rate) on the net amount of its deferred items exceeds its gross asset value, the corporation is not required to accelerate the inclusion of any remaining deferred discharge of indebtedness income.

b. Acceleration on Change in Tax Status: If an electing C corporation elects to change its status (i.e., become an S corporation, REIT or RIC), the corporation must take into account its deferred discharge of indebtedness income immediately before the election to change its status is effective.

c. Acceleration on Cessation of Existence: Generally, if a C corporation ceases its business, deferred items must be taken into account in the taxable year of the cessation under Section 108(i)(5)(D).

(1) The Temporary Regulations provide an exception if the assets of the electing C corporation are acquired in a transaction in which Section 381(a) applies.

(2) However, the Temporary Regulations limit the applicability of the Section 381 exception in certain circumstances.
(a) For example, if the assets of the domestic electing C corporation are acquired by a foreign corporation in a Section 381 transaction, then the electing corporation’s deferred cancellation of indebtedness income may be subject to tax when it is includible in the foreign acquirer’s gross income.

(b) If the assets of an electing corporation are acquired by a RIC or a REIT in a transaction that is subject to both Section 381 transaction and Reg. § 1.337(d)-7 (a conversion transaction), the electing C corporation must take into account its remaining deferred cancellation of indebtedness income immediately before the transaction.

(c) If the assets of an electing corporation are acquired by an S corporation in a transaction that is subject to Sections 381(a) and 1374(d)(8), the electing corporation must take into account its remaining deferred cancellation of indebtedness income immediately before the transaction.

d. **Interface between Section 108(i) and OID Deductions:** Section 108(i)(2) provides that if, as part of a reacquisition of debt to which Section 108(i) applies, a debt instrument is issued and there is any original issue discount (“OID”) with respect to the debt instrument, the issuer may not take a deduction for the portion of the OID that accrues before the 5-year inclusion period and that exceeds the discharge of indebtedness income with respect to the applicable debt instrument being acquired.

(1) The Temporary Regulations provide a mathematical equation to determine the amount of OID accrual if a portion of the proceeds of a debt instrument with OID are used to reacquire the applicable debt instrument. (OID accrual times the portion of the proceeds of the debt instrument used to reacquire the applicable debt instrument divided by the total proceeds of the debt instrument.)

(2) In addition, the Temporary Regulations provide a matching rule regarding the inclusion of OID income and the claiming of OID deductions (i.e., OID deductions will be accelerated when the corresponding deferred OID income is taken into account).

3. **Application of Section 108(i) to Partnerships and S Corporations.** The two major concerns addressed by the Temporary Regulations for partnerships and S corporations are: (a) the method to allocate discharge of indebtedness income and (b) the operation of the deferral rules under Section 108(i)(5)(D), which accelerates the inclusion of a taxpayer’s remaining deferred discharge of indebtedness income in certain instances.

a. **Allocation of Discharge of Indebtedness Income:** Section 108(i) provides different rules for allocating discharge of indebtedness income for partnerships and S corporations. The Temporary Regulations provide guidance for both entities.

(1) **Partnerships:** An electing partnership that defers any portion of the discharge of indebtedness income realized from the reacquisition of an applicable debt instrument under Section 108(i) must allocate all of such discharge of indebtedness income to its direct partners prior to the transaction giving rise to the discharge of indebtedness income. Recognizing that there are instances in which the inclusion of discharge of indebtedness income
would be beneficial to some (but not all) partners, the Temporary Regulations permit an electing partnership to determine the portion of each partner’s allocable share of discharge of indebtedness income that is deferred and the portion that is not deferred. The electing partnership may allocate all of the discharge of indebtedness income to its partners in the manner in which the income would be included in the distributive shares of the partners under Section 704 and Reg. § 1.704-1(b)(2)(iii), without regard to Section 108(i).

(2) **S Corporations:** The Temporary Regulations provide that any deferred discharge of indebtedness income of an electing S corporation be shared pro rata, on the basis of stock ownership, among those shareholders that held stock immediately prior to the transaction giving rise to such income.

### b. Acceleration Events Triggered on Change Arising at the Partnership or S Corporation Level

The Temporary Regulations provide a list of actions which, if undertaken by an electing partnership or S corporation, will be considered an acceleration event. For example, an acceleration event will occur if the electing entity:

1. Liquidates;
2. Sells, exchanges or transfers “substantially all” of its assets;
   - (a) “Substantially all” means assets representing at least 90% of the fair market value of the entity’s net assets and at least 70% of the fair market value of the entity’s gross assets.
   - (b) In general, if an electing partnership holds an interest in another partnership (the “lower tier partnership”) and the lower tier partnership sells its assets, this sale will not be treated as an acceleration event.
3. Ceases to do business; or
4. Files a petition in a Title 11 or similar case.

### c. Acceleration Events Triggered on Change Arising at the Partner or Shareholder Level

The Temporary Regulations expand on the list of actions which, if undertaken by a partner or shareholder, will be considered an acceleration event.

1. With respect to a partner of an electing partnership, generally, the deferred items allocated to such partner are accelerated if the partner:
   - (a) Dies or liquidates;
   - (b) Sells, exchanges, transfers or gifts all or a portion of his/her/its separate interest in the electing entity;
   - (c) Has his/her/its separate interest redeemed; or
   - (d) Abandons his/her/its separate interest.
With respect to a shareholder of an electing S corporation, generally, the deferred items allocated to such shareholder are accelerated if the shareholder:

(a) Dies;

(b) Sells, exchanges, transfers or gifts all or a portion of his/her/its separate interest; or

(c) Abandons his/her/its separate interest.

Mitigation Provisions: The Temporary Regulations provide a list of undertakings that will not be considered an acceleration event.

(a) A contribution of assets by an electing partnership to another partnership in a transaction governed by Section 721 will not be considered an acceleration event.

(b) A like-kind exchange of property by an electing partnership or S corporation pursuant to Section 1031 will not be considered an acceleration event.

(c) A technical termination of an electing partnership or partnership that is a partner of an electing partnership under Section 708(b)(1)(B) will not be considered an acceleration event.

4. Effective Date. In general, the Temporary Regulations are effective for reacquisitions of applicable debt instruments in taxable years ending after December 31, 2008. However, generally, Temp. Reg. § 1.108(i)-1T(b) (the provision discussing acceleration events for C corporations) applies to acceleration events occurring on or after August 11, 2010; nevertheless, taxpayers can apply these rules to acceleration events that occurred prior to August 11, 2010 by taking a return position consistent with these provisions.

D. Sections 108 and 721 (Transfer of Partnership Interest to Creditor).

1. Overview. On October 30, 2008, the Treasury issued Proposed Regulations which provide guidance regarding the calculation of cancellation of indebtedness income resulting from a partnership’s transfer of a partnership interest to a creditor in satisfaction of the partnership’s indebtedness (a “debt-for-equity exchange”) under Section 108(e)(8).

2. Value of Partnership Interest. For purposes of determining the fair market value of the partnership interest transferred to the creditor, the partnership can use the liquidation value of the interest (the amount of cash the creditor would receive for its interest if, immediately after the transfer, the partnership sold all its assets for cash equal to the fair market value of those assets and then liquidated). The following additional requirements must also be satisfied in order for the transaction to not be tested under a facts and circumstances regime.

a. The debtor partnership must determine and maintain capital accounts of its partners in accordance with the capital accounting rules of Section 704;
b. The creditor, debtor partnership, and its partners must treat the fair market value of the indebtedness as being equal to the liquidation value of the creditor’s debt-for-equity interest for purposes of determining the tax consequence of the debt-for-equity exchange;

c. The debt-for-equity exchange must be an arms’-length transaction; and

d. Subsequent to the debt-for-equity exchange, neither the partnership redeems nor any person related to the partnership can purchase the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange which has as a principal purpose the avoidance of cancellation of indebtedness income by the partnership.

3. Application of Section 721 to Exchange. In general, the non-recognition rule of Section 721 will apply to the creditor’s contribution of partnership indebtedness (other than unpaid rent, royalties or interest on indebtedness, including accrued original issue discount). If the amount of the indebtedness is more than the liquidation value, the creditor will not recognize a loss on the contribution. Instead, the creditor’s basis in the equity interest will be increased by the adjusted basis of the indebtedness.

a. Certain tax practitioners are proposing that the debt-for-equity exchange be bifurcated into two components, the cancellation of a portion of the debt and the contribution of the balance in exchange for a partnership interest.

b. There is also concern regarding the exclusion of unpaid rent, royalties and interest for accrual method creditors.

E. Sections 195, 248 and 709 (Elections for Corporation and Partnership Organizational Expenses).

1. Overview. On August 17, 2011, the Service issued Final Regulations relating to the election to deduct start-up expenditures, organizational expenditures of corporations and organizational expenses of partnerships, under Sections 195, 248 and 709, respectively. The Final Regulations set forth the manner to elect to amortize such expenses.

2. General Rule for Making Election. Taxpayers are not required to file a separate election statement to deduct costs under Section 195, 248 or 709. Instead, under the Final Regulations, taxpayers are deemed to have made an election to amortize such expenses for the year in which the active trade or business to which the expenditures relates begins, under Section 195, or the year in which the corporation or partnership begins business, under Section 248 or 709, respectively. Regs. §§1.195-1(b), 1.248-1(c) and 1.709-1(b)(2).

3. Forgo Election. To forgo the deemed election, a taxpayer must affirmatively elect to capitalize its start-up or organizational expenses on a timely filed Federal income tax return (including extensions). Regs. §§1.195-1(b), 1.248-1(c) and 1.709-1(b)(2).

4. Effective Date. The Final Regulations apply to expenditures paid or incurred after August 16, 2011. However, taxpayers may apply the provisions of Sections 195,
248 and 709 to expenditures paid or incurred after October 22, 2004, provided that the period of limitations on assessment of tax for the year the election under Sections 195, 248 and 709 is deemed made has not expired.

F. Section 704 (Accounting Tax Liabilities of Partners in Applying Anti-Abuse Rules Under Section 704).

1. Overview. On May 28, 2010, the Service issued Final Regulations under Section 704(c) to extend the anti-abuse rules to take into account the tax liabilities of direct and indirect partners. The Final Regulations are substantively similar to the Proposed Regulations issued on May 19, 2008.

2. General Rule. Under the anti-abuse rule of Section 704, an allocation method is not reasonable if there is a shifting of the tax consequences of built-in gain or loss among the partners which results in a substantial reduction of the present value of the partner’s aggregate tax liability. Because the Service believes that failure to consider a substantial reduction of an indirect partner’s tax liability would be inconsistent with the anti-abuse principles, the Service amended Reg. § 1.704-3(a)(10). The Regulation provides that, for purposes of applying the anti-abuse rules, the tax effect of an allocation method (or combination of methods) on direct and indirect partners must be taken into account.

3. Indirect or Direct Partner. An indirect partner is the direct or indirect owner of a partnership, S corporation or controlled foreign corporation (only with respect to the allocation of items that would be considered Section 951 income), or a direct or indirect beneficiary of a trust or estate and any consolidated group of which the partner in the partnership is a member.

4. Recast by Service. The Regulations further provide that the principles of Section 704(c) apply only to contributions of property. Therefore, even if the partnership’s allocation method literally follows the rules of the Regulation, the Service can still recast the contribution as appropriate to avoid tax results inconsistent with the intent of Subchapter K.

5. Effective Date. The Final Regulations are effective for tax years beginning after June 9, 2010.

G. Section 1001 (Modification of Debt Instruments).

1. Overview. Section 1001 provides that a “significant” modification of debt results in a deemed exchange of the original debt instrument for the modified one. Regulation §1.1001-3 provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of Section 1001.

2. General Rule. For purposes of determining if there has been a significant modification to a debt instrument, Reg. § 1.1001-3(e)(5)(i) provides that any deterioration in the financial condition of the obligor between the issue date of the unmodified instrument and the date of modification (as it relates to the obligor's ability to repay the debt) is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor.
3. **Clarification.** Taxpayers were concerned that a decline in the creditworthiness of an issuer, under certain conditions, could be considered a significant modification. To provide guidance, the Service issued Prop. Reg. §1.1001-3(f), which was finalized on January 7, 2011. The Final Regulations provide a rule similar to that currently provided in Reg. §1.1001-3(e)(5)(i); however, the Final Regulations provide clarification.

   a. First, the Final Regulations provide an example which states that “any decrease in the fair market value of a debt instrument (whether or not the debt instrument is publicly traded) between the issue date of the debt instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the obligor and not to a modification of the terms of the instrument”. In other words, a decrease in the fair market value of a debt instrument solely resulting from the debtor’s financial difficulties will be disregarded.

   b. Second, the Final Regulations clarify that, if there is a substitution of a new obligor or the addition or deletion of a co-obligor, the general rule disregarding the financial condition of the obligor for purposes of determining if there is a modification is not applicable.

   c. Third, the Final Regulations provide that the rules discussed above are applicable for purposes of determining whether the modified instrument received in an exchange will be classified as debt for Federal income tax purposes.

4. **Effective Date.** Final Reg. §1.1001-3(f)(7) [which is discussed in Part III J.3.a. and b. above] applies to an alteration of the terms of debt instrument made on or after January 7, 2011. However, taxpayers may rely on these rules for alterations of a debt instrument occurring before that date. The remainder of the Final Regulations generally apply to alterations of the terms of a debt instrument made on or after September 24, 1995. Taxpayers, however, can rely on these Regulations for alterations of the terms of a debt instrument after December 2, 1992 and before September 24, 1996.

   H. **Section 1273 (Determination of Issue Price).**

   1. **Overview.** Upon issuance of a debt instrument or material modification of a debt, the issuer needs to determine the issue price of such instrument. In general, that determination is made pursuant to the rules set forth in Section 1273 (unless the instrument is issued for property). Under Section 1273, the issue price of a debt instrument issued for property, part or all of which is traded on an established securities market, is equal to the fair market value of the instrument. Under existing Regulations, an instrument generally is considered traded on an established market if (a) it is traded on a specified exchange; (b) it is traded on a contract market designated by the Commodities Futures Trading Commission; (c) it appears on a system of general circulation that disseminates price quotations or recent trading prices; or (d) price quotations are readily available from dealers, brokers or traders. Under the Proposed Regulations, new rules would apply to determine whether or not a debt instrument is publicly traded.
2. **General Rule.** Under the Proposed Regulations, an instrument will be considered to be publicly traded if it satisfies one of four tests, as follows:

   a. The instrument is listed on an exchange.

      (1) The Proposed Regulations expand the definition of an exchange.

      (2) It includes foreign securities exchanges that are officially recognized, sanctioned, regulated or supervised by a governmental authority of the foreign country in which the market is located.

   b. There is a sales price for the instrument that is “reasonably available”. The price of a debt instrument is considered reasonably available if the sales price (or information sufficient to calculate the sales price) appears in a medium that is made available to persons that regularly purchase or sell debt instruments (including a price provided only to certain customers or to subscribers), or persons that broker purchases or sales of debt instruments.

   c. There are one or more firm quotes for the instrument.

   d. There are one or more indicative quotes (i.e., a “soft quote”) for the instrument. An indicative quote is considered to exist when a price quote is available from at least one broker, dealer or pricing service (including a price provided only to certain customers or to subscribers) for property and the price quote is not a firm quote.

3. **Effective Date.** The Proposed Regulations are effective for debt instruments issued on or after the date the Final Regulations are published.

I. **Section 6012 (Uncertain Tax Positions).**

1. **Overview.** In a series of Announcements, the Service developed a Schedule requiring certain businesses to report uncertain tax positions on their tax returns. The draft Schedule and Instructions provide that, beginning with the 2010 tax year, certain corporations which have assets equal to or exceeding $10 million and have uncertain tax positions will be required to file a Schedule UTP, along with their tax returns, if they (or a related party) had audited financial statements. In September of 2010, the Service issued Proposed Regulations; and on December 13, 2010, the Proposed Regulations were adopted without substantive changes.

2. **General Rule.** The Regulations authorize the Service to require corporations to file a Schedule UTP, Uncertain Tax Position Statement, as set out in the forms, instructions and other appropriate guidance provided by the Service.

3. **Effective Date.** The Final Regulations are effective for tax years beginning on or after January 1, 2010.
J. Sections 6011, 6071, and 7701 (Series LLCs and Cell Companies).

1. Overview. A handful of states have statutes that provide that a limited liability company (an “LLC”) can establish separate series (commonly referred to as “series LLCs”). Although each series of a series LLC is not treated as a separate entity for state law purposes and cannot have separate members, it has “associated” with it certain members, rights, business objectives and obligations. In addition, often times a state’s statute provides that the debt of one series is enforceable only against the assets of that series and not against the assets of other series or the series LLC. In addition to enacting statutes regarding series LLCs, several states have enacted similar statutes for the establishment of a “cell company”. A cell company is a segregated account company or segregated portfolio company which establishes multiple accounts (or cells). Like a series, each cell is identified with a specific participant but is not considered a distinct legal entity for state law purposes. In addition, the assets of each cell are protected from the creditors of any other cell and from the creditors of the cell company. The Proposed Regulations define a series LLC, cell company and other similarly situated entity as a “series organization” and define a series, cell and the like as a “series”.

2. General Rule. The Proposed Regulations provide that a series is treated as an entity formed under local law. Whether such series is treated as a separate entity for Federal tax purposes is determined under the general tax principles of Reg. § 301.7701-1(b). The Proposed Regulations do not address the entity status of the series organization for Federal tax purposes.

3. Ownership of Assets of a Series. The Proposed Regulations provide that a series organization is not treated as the owner of a series merely because it holds legal title to the assets associated with the series. This determination will be made under general tax principles (i.e., which entity bears the economic benefits and burdens of the assets). According to the Proposed Regulations, the same principles will apply to determine who owns an interest in a series and series organization.

4. Identifying Information. Recognizing that a series or a series organization may be treated as a separate entity for Federal tax purposes but not local law purposes, the Service believed that a new statement needed to be created which would be filed annually by series organization and each series. As a result, the Proposed Regulations propose to amend Section 6011 to include this requirement.

5. Effective Date. Generally, the Proposed Regulations are effective on the date the Final Regulations become publicized. At that time, taxpayers that treat series differently for Federal tax purposes than series are treated under the Final Regulations will be required to change their treatment of the series. For purposes of determining the consequences of the conversion from one entity to multiple entities, the Proposed Regulations state that general tax principles will apply. In addition, the Proposed Regulations provide an exception for series established prior to September 14, 2010 (the publication date of the Proposed Regulations) that treat all series and the series organization as one entity.
IV. NOTICES, MEMORANDA, ACTIONS ON DECISIONS AND DIRECTIVES

A. Notice 2011-6, 2011-3 I.R.B. 315. This Notice provides guidance regarding the implementation of Reg. §1.6109 regarding tax return preparers. Among other items, this Notice discusses the requirement that tax return preparers obtain a preparer tax identification number (“PTIN”). Specifically, the Notice provides that tax return preparers who are supervised by attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents or certain enrolled actuaries do not need to take a competency examination or continuing education requirements to obtain a PTIN, if they do not sign the tax return.

B. Notice 2011-56, 2011-29 I.R.B. 54. In this Notice, the Service provides interim guidance on issues relating to the basis of stock and broker reporting requirements. A taxpayer may use the average basis method to determine the basis of stock in regulated investment companies (“RICs”) and in connection with a dividend reinvestment plan (“DRP”). If a taxpayer does not use the average basis method, the basis of stock is its cost. Beginning in 2012, to elect the average basis method, a taxpayer needs to notify the broker in writing. If the taxpayer wants to revoke the average basis method and revert to the cost basis method, it must make such revocation within one year of the election or by the first disposition date of the stock, whichever is earlier.

Section 6045 imposes reporting requirements on brokers on the sale of stock. Brokers must report the “adjusted basis” of the stock sold and whether the gain or loss is long or short-term. The adjusted basis is determined by a broker’s default method, unless the taxpayer elected another method.

To provide consistency between a taxpayer’s revocation of an election to use the average basis method and a taxpayer’s revocation of a broker’s default method, this Notice provides that, when a taxpayer wants to change from a broker’s default average basis method for stock in a RIC or DRP, the taxpayer must request a change by the earlier of one year after receiving notice from the broker of its default method or the date of the first disposition of the stock, whichever is earlier.

In addition to providing rules regarding basis methods, this Notice provides that a DRP will not fail to meet the 10% dividend reinvestment requirement if it pays a cash dividend in lieu of fractional shares, where the amount of the dividend is insufficient for some shareholders to acquire stock.


The executor may make a Section 1022 Election by filing an IRS Form 8939, “Allocation of Increase in Basis for Property Acquired From a Decedent”, on or before January 17, 2012. Prior filings purporting to make the Section 1022 Election must be replaced with a
timely filed Form 8939. The Service will not grant extensions of time to file a Form 8939, except in certain specified limited circumstances.

The Notices also provide that, if the executor makes the Section 1022 Election, the executor allocates that decedent’s available GST exemption by attaching the Schedule R of Form 8939. If the Form 8939 is timely filed, this allocation will be considered a timely allocation of the decedent’s GST exemption under Section 2632.

With respect to inter vivos direct skips that occur in 2010, if the donor wishes to pay GST tax (at a 0% rate) and does not wish to allocate any GST exemptions to that transfer, the donor may elect out of the automatic allocation of GST exemption by either affirmatively electing out of the allocation or reporting the inter vivos direct skip not in trust on a timely filed Form 709. The due date for filing a Form 709 reporting a direct skip that occurred on or after January 1, 2010 through December 16, 2010 was September 19, 2011, including extensions, except in the case of a Schedule R attached to Form 8939, which is due on or before January 17, 2012.

D. AOD 2010-002, 2010-14 I.R.B. After losing several cases on this issue, the Service acquiesced in the decision by the Court of Federal Claims in Thompson v. United States, 104 AFTR 2d 2009-5381 (Fed. Cl. 2009), holding that an interest in a limited liability company is not considered an interest in a limited partnership for purposes of Section 469. As a result, Section 469(h)(2), which treats a limited partnership interest as intrinsically passive, is inapplicable to a limited liability company interest.

E. IRS LB&I Directive 4-0711-015. In a previous Directive, it was stated that any proposal by a revenue agent/manager to impose the economic substance doctrine codified in Section 7701(o) must be reviewed and approved by the appropriate Director of Field Operations (“DFO”). This Directive provides a series of inquiries an agent/examiner must develop and analyze in order to seek the approval of the DFO to raise the economic substance doctrine.

V. REVENUE PROCEDURES

A. Rev. Proc. 2010-14, 2010-12 I.R.B. 456. Realizing that many taxpayers were unable to complete deferred like-kind exchanges because their qualified intermediaries defaulted on their obligations to acquire and transfer replacement property (a “QI default”), the Service issued this Revenue Procedure, which provides that a qualified taxpayer does not need to recognize gain from the failed exchange until the taxable year in which such taxpayer receives a payment attributable to the relinquished property. To avail itself of the benefits of this Revenue Procedure, the taxpayer must have:

1. Relinquished the property to a qualified intermediary in accordance with Reg. § 1.1031(k)-1(g)(4);

2. Identified replacement property within the identification period (unless the QI default occurred during that period);
3. Not been able to complete the like-kind exchange solely because of the QI default involving a qualified intermediary that became subject to a bankruptcy proceeding under the United States Code or a receivership proceeding under Federal or state law; and

4. Not been in actual or constructive receipt of the proceeds (disregarding any proceeds actually or constructively received by the qualified intermediary) from the disposition of the relinquished property or any property of the qualified intermediary prior to the time the qualified intermediary entered bankruptcy or receivership.

   a. Generally this Revenue Procedure is effective for taxpayers whose like-kind exchanges failed because of a QI default occurring on or after January 1, 2009.

   b. However, a taxpayer who is within the scope of this Revenue Procedure may, subject to the Section 6511 limitations on credit or refund, file an original or amended return to report a deferred like-kind exchange that failed due to a QI default in a tax year ending before January 1, 2009, in accordance with this Revenue Procedure.

B. Rev. Proc. 2010-30, 2010-36 I.R.B. 316. Many commercial mortgage loans are held in real estate mortgage conduits (“REMICs”), which are essentially pass-through vehicles. Among the requirements for qualification as a REMIC is that the mortgage loans held by the REMIC are considered qualified mortgage loans that are principally secured by an interest in real property. In order to assist REMICs in dealing with the current financial upheaval, in this Revenue Procedure, the Service provides certain situations in which it will not challenge whether a mortgage loan fails to be principally secured by an interest in real property because of a release of a lien on an interest of real property that secured the loan. Specifically, the Service will not challenge a release of a lien that is effected by either a “grandfathered transaction” or a “qualified pay down transaction”.

1. A “grandfathered transaction” is any release of a lien on an interest in real property that satisfies the following two requirements:

   a. The lien release occurs by operation of the terms of the debt instrument and, therefore, is not considered a modification for purposes of Reg. § 1.1001-3(c); and

   b. The terms for the lien release are contained in a contract executed on or before December 6, 2010.

2. A “qualified pay down transaction” is the release of a lien in a transaction which requires a payment by the borrower resulting in a reduction in the adjusted issue price of the loan by a “qualified amount”.

   a. A “qualified amount” is an amount that is equal to or greater than at least one of the following:

      (1) The sum of (a) the net proceeds available to the borrower from an arms’-length sale of the property to an unrelated person, (b) the net proceeds from the
receipt of a condemnation award with respect to the property, and (c) the net proceeds from the
receipt of an insurance or tort settlement with respect to the property.

(2) An amount that is determined under a loan agreement that
equals or exceeds the product of (a) the adjusted issue price of the obligation at the time of the
lien release multiplied by (b) a fraction equal to the fair market value at origination of the
released interest divided by aggregate fair market value at origination of all the interests that
secured the loan immediately before the lien release.

(3) The fair market value of the interest in real property on
which the lien is released plus the amount of any tort or insurance settlement that has, or is
expected to be, received, and that is not already reflected directly or indirectly in the property’s
fair market value.

(4) An amount such that, immediately after the transaction, the
ratio of the adjusted issue price of the loan to the fair market value of the interest in real property
securing the loan is no greater than what the ratio was immediately before the transaction.

3. This Revenue Procedure applies to releases of liens on interests in real
property securing mortgage loans held by REMICs that are effected on or after September 16,
2009.

estate prices, this Revenue Procedure provides a safe harbor for the treatment of the modification
of certain mortgage loans for purposes of the income and assets test under Section 856(c). In
general, if the loan value of real property is equal to or exceeds the amount of the loan, then all
the interest income from the loan is considered a “real estate asset” for purposes of Section
856(c). The “loan value” is determined as of the date on which the commitment became binding
on the REIT, and the “amount of the loan” is the highest principal amount of the loan
outstanding during the year. However, under this Revenue Procedure, if: (1) the modification
resulted from a default or (2) the REIT or servicer of the loan reasonably believes that (i) there is
a significant risk of default of the pre-modified loan on maturity or at an earlier date and (ii) the
modified loan presents a substantially reduced risk of default when compared with the pre-
modified loan, then:

1. The REIT may treat the modification as not being a new commitment to
make or purchase a loan for purposes of determining the loan value of the real property;

2. The loan will not be treated as a prohibited transaction under Section
857(b)(6); and

3. The REIT’s treatment of the loan as being part of a real estate asset for
purposes of Section 856(c)(4) will not be challenged by the Service, so long as the REIT treats
the loan as being a real estate asset in an amount equal to the lesser of the value of the loan or the
loan value of the real property securing the loan as determined under the Regulations and this
Revenue Procedure.
D. Rev. Proc. 2011-26, 2011-16 I.R.B. 664. To assist taxpayers with taking additional first year deductions under Section 168(k), this Revenue Procedure provides guidance regarding what property qualifies for the additional deductions and a detailed description of special rules and limitations. The Revenue Procedure provides six examples regarding acquired and self-constructed property, component elections, and the Section 280(F)(a) safe harbor method of accounting. The Revenue Procedure also provides the time and manner of making an election not to deduct additional first year depreciation. Finally, the Revenue Procedure provides guidance regarding the retroactive application of the 50% additional first year depreciation deduction for taxpayers who did not claim the additional deductions for property placed in service after December 31, 2009 on their Federal tax returns for the taxable year beginning in 2009 and ending in 2010 or on their 2010 short taxable year returns.

E. Rev. Proc. 2011-29, 2011-18 I.R.B. 746. In a business acquisition, the treatment of amounts that are contingent on the successful closing of a transaction (also known as success-based fees) has been a subject of controversy between taxpayers and the Service. Reg. §1.263(a)-5(a) provides that a taxpayer must capitalize amounts paid to facilitate certain transactions. Reg. §1.263(a)-5(f) provides that a success-based fee will be considered to facilitate a transaction (and thus must be capitalized), except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. In order to eliminate controversy over the allocation of success-based fees to activities that do not facilitate the transaction, in this Revenue Procedure the Service established a safe harbor to permit taxpayers who pay or incur a success-based fee in a “covered transaction”, as defined in Reg. §1.263(a)-5(e)(3), to elect to treat 70% of the costs so paid as amounts not paid to facilitate the transaction. To make the election, the taxpayer must attach a statement to its original Federal income tax return for the taxable year in which the success-based fee is paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the success-based fee amounts that are deducted and capitalized. The election, once made, is irrevocable. The Revenue Procedure is effective for success-based fees paid or incurred in taxable years ending on or after April 8, 2011.

F. Rev. Proc. 2011-34, 2011-24 I.R.B. 875. In this Revenue Procedure, the Service provides procedures that will allow taxpayers to make late elections to treat all interests in rental real estate as a single rental activity under Reg. §1.469-9(g), in lieu of requesting a letter ruling.

1. To obtain this relief, a taxpayer must attach a statement, under penalties of perjury, to an amended return which provides that:
   
   a. The taxpayer failed to make an election solely because it failed timely to meet the requirements set forth in Reg. §1.469-9(g);
   
   b. The taxpayer filed consistently with having made an election under Reg. §1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election;
   
   c. The taxpayer timely filed each return that would have been affected by the election if it had been timely made; and
d. The taxpayer has reasonable cause for its failure to meet the requirements set forth in Reg. §1.469-9(g).

2. In addition, the statement must explain the reason for the failure to file a timely election and must identify the taxable year for which it seeks to make the late election.

3. The statement must state at the top of the document “FILED PURSUANT TO REV. PROC. 2011-34”.

4. This Revenue Procedure is effective as of June 13, 2011. It also applies to all ruling requests pending in the National Office on June 13, 2011, as well as requests for relief received thereafter. The National Office will decline to rule on all ruling requests currently pending as of June 13, 2011 and will refund the user fee.

G. Rev. Proc. 2011-41, 2011-35 I.R.B. 188. TRA 2010 provides that the executor of an estate of a decedent who died in 2010 can elect out of the estate tax and instead utilize the modified carry-over basis rules of Section 1022 (the “Section 1022 Election”). This Revenue Procedure, along with Notices 2011-66, 2011-35 I.R.B. 179 and 2011-76, 2011-40 I.R.B. ____, provides guidance to executors who make a Section 1022 Election. The Revenue Procedure provides that, if an executor follows certain conditions, the Service will not challenge the basis amount of the property.

1. First, the property must be “acquired from a decedent”.
   a. In general, the property must be acquired by bequest, devise or inheritance, or by the decedent’s estate from the decedent.
   b. Property that constitutes a right to receive an item of income in respect of a decedent under Section 691 and annuities subject to income tax under Section 72 are not considered “acquired from a decedent”.
   c. In addition, property transferred must be owned by the decedent at death to be considered “acquired from the decedent”. For example, if the property was transferred to a trust during the decedent’s life in which the decedent retained a power to alter, amend or terminate the trust, then the property will not be considered “acquired from a decedent”, unless the terms of the trust require the trust property to revert back to the decedent upon death.

2. Second, the property must be eligible for the allocation of basis increase.
   a. The property may not have been acquired by the decedent by gift or inter vivos transfer for less than adequate and full consideration in money or money’s worth during the three-year period prior to the decedent’s death, unless it was acquired by the decedent’s spouse and such spouse had not acquired the property for less than adequate and full consideration in money or money’s worth during the three-year period prior to his/her death.
   b. Additionally, the property must not be stock or securities in a foreign personal holding company, a DISC (or former DISC), a foreign investment company or a
passive foreign investment company, unless such company is a qualified electing fund under Section 1295 with respect to the decedent.

3. Third, the increase in basis must not exceed the sum of the “general basis increase” and the “spousal property basis increase”.
   a. The general basis increase is equal to:
      (1) the $1,300,000 basis increase under Section 1022(b)(2)(B);
      (2) the amount of the decedent’s capital loss and net operating carryovers that would (but for the decedent’s death) have been carried from the decedent’s last taxable year to a later taxable year; and
      (3) the amount of unrealized losses that would have been allowable under Sections 165(c)(1) and (2) if the property acquired from the decedent had been sold at FMV immediately before his/her death.
   b. The spousal property basis increase is the $3,000,000 increase under Section 1022(c)(2).

4. Fourth, the allocation of the basis increase must satisfy certain rules. In general, the executor may allocate the basis increase to the property owned by and acquired from the decedent on a property-by-property basis, so long as the decedent’s adjusted basis in each property does not exceed the FMV of that property at the decedent’s death.

5. Fifth, the FMV of the property acquired from the decedent who died in 2010 must be determined in the same manner for purposes of Section 1022 as for purposes of the estate tax. As a result, appraisals required under Section 2031 to determine the FMV of certain property included in the gross estate for Federal estate tax purposes also apply for purposes of determining the FMV of property under Section 1022.

6. The Revenue Procedure also provides special rules for community property held by a decedent and the surviving spouse. The rules focus on the amount of the basis increase, the surviving spouse’s basis in the property, the amount of unrealized losses allowable to both the decedent and surviving spouse, and the amount of net operating loss and capital loss carryovers eligible to be included in the general basis increase.

7. Finally, the Revenue Procedure explains the interaction of Section 1022 with certain other income tax provisions.
   a. For example, it provides that, if the recipient’s basis is determined under Section 1022, the recipient’s holding period includes the period such property was held by the decedent, regardless of whether the executor allocated any basis increase to the property.
   b. Also, it states that, if Section 1022 applies and the property is depreciable property, the recipient is treated for depreciation purposes as the decedent for the
portion of the recipient’s basis in the property that equals the decedent’s adjusted basis in such property.

8. The Revenue Procedure is effective August 29, 2011; however, taxpayers can apply the safe harbor for prior periods.

VI. REVENUE RULINGS

A. Rev. Rul. 2010-16, 2010-26 I.R.B. 769. This Ruling, along with Rev. Rul. 2010-17 (see Part VI.B.), provides guidance to taxpayers claiming the new markets tax credit. The focus of this Ruling is the interplay of the passive activity loss rules with a taxpayer’s equity investment in a community development entity (a “CDE”). In general, the passive activity rules provide that, in order for an activity to be considered a passive activity, the activity must be either (a) in connection with the conduct of a trade or business in which the taxpayer does not materially participate or (b) a rental activity. Because the acquisition of an investment interest in a CDE can never be considered a rental activity, it will only be considered a passive activity if the acquisition of the investment interest is considered in connection with the conduct of a trade or business of the taxpayer and the taxpayer does not materially participate in such trade or business.

B. Rev. Rul. 2010-17, 2010-26 I.R.B. 769. This Ruling provides guidance on the new markets tax credit. In Rev. Rul. 2003-20, 2003-1 C.B. 465, the Service held that the amount of a partnership’s equity investment in a CDE includes cash from a non-recourse loan to the partnership. This Ruling provides that a partnership’s equity investment in a CDE will also include cash from a recourse loan to the partnership.

VII. PRIVATE LETTER RULINGS

A. Priv. Ltr. Rul. 201113002 (December 2, 2010). Taxpayer, a corporation which intended either to elect to be treated as a real estate investment trust (“REIT”) or to merge with an existing corporation that would elect to be treated as a REIT, was in the business of making loans to real property owners who had failed to pay their real property taxes (the “Tax Loans”). Taxpayer and the owner would enter into a loan agreement. Taxpayer would pay the state government (the “Tax Unit”) the amount of the real property tax liability due on behalf of a property owner. The Tax Unit would sign a document transferring to Taxpayer its statutory lien on the owner’s real property when the owner failed to pay its real property taxes. This statutory lien was senior to the lien held by the first mortgage holder (a “super priority lien”).

There were many restrictions on the amount and use of a Tax Loan made by Taxpayer. For example, the Tax Loan could not be in an amount exceeding the property tax liability and related closing costs. In addition, the entire amount of the Tax Loan had to be used to pay the tax liability and related closing costs.

The question presented was whether the Tax Loans were secured by real property and thus qualified as real estate assets under Section 856. Because (i) the Tax Loans arose through an agreement between the Taxpayer and the owner with respect to real property, (ii) the Taxpayer had a super priority lien on the property, and (iii) the owner transferred a note and deed
of trust for the benefit of Taxpayer in exchange for the relevant Tax Loan, the Service ruled that the Tax Loans qualified as real estate assets.

B. Priv. Ltr. Rul. 201115001 (January 4, 2011). Taxpayer, a common parent of an affiliated group, acquired all of the outstanding stock of Corporation Z. Corporation Z was the common parent of an affiliated group, which included Subsidiary. Corporation Z merged with and into Taxpayer and, as a result, Taxpayer became the sole shareholder of Subsidiary. Taxpayer caused Subsidiary to convert under state law to a limited liability company. Because Subsidiary was wholly owned by Taxpayer, the conversion caused Subsidiary’s Federal tax classification to change from a corporation to a disregarded entity. Before the conversion, Subsidiary was insolvent. Taxpayer requested a ruling that it could claim a worthless stock loss under Section 165(g) as a result of the conversion. Because the conversion was considered an identifiable event under Section 165 and Rev. Rul. 2003-125, 2003-2 C.B. 1243, the Service ruled Taxpayer could claim a worthless stock loss under the consolidated return regulations as a consequence of Subsidiary’s conversion.

C. Priv. Ltr. Rul. 201118015 (May 6, 2011). Taxpayer, a REIT, owned substantially all of its assets and conducted most of its business through a limited partnership, OP. Taxpayer intended to raise capital through a public offering of debentures, the proceeds of which would be loaned by Taxpayer to OP.

Under the assets and income tests of Section 856, a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and is entitled to the income of the partnership attributable to that share. The interest of a partner in the partnership’s assets is determined in accordance with the partner’s capital interest in the partnership.

Because the Taxpayer was required to account for its proportionate share of OP’s income and assets under Section 856, the Service ruled that, to the extent payments on the loan from Taxpayer to OP were already reflected in Taxpayer’s income and assets, those payments should be disregarded for Section 856 purposes, to avoid such items from being double counted.

D. Priv. Ltr. Rul. 201119001 (February 4, 2011). Taxpayer, a REIT, leased industrial facilities, either directly or indirectly through domestic and foreign subsidiaries. In addition, Taxpayer owned, directly or indirectly through disregarded entities or foreign partnerships, stock of several foreign subsidiaries which elected to be treated as taxable REIT subsidiaries. The foreign subsidiaries were either controlled foreign corporations or passive foreign investment companies.

Taxpayer was required to include certain amounts in income as a result of being a United States shareholder in controlled foreign corporations and a shareholder in passive foreign investment companies. Taxpayer was concerned that such amount would exceed 5% of its gross income, causing it to fail the gross income test under Section 856.

In general, Section 856(c)(2) requires that at least 95% of a REIT’s gross income must be derived from dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities and real property, interests in mortgages on property which is not
described in Section 1221(a)(1) and other sources. Section 856(c)(5)(J) provides that the Secretary is authorized to determine that items of income or gain which do not qualify under Section 856(c)(2) or (3) may be considered “qualifying” gross income, to the extent necessary to carry out the purposes of the Code sections for RICs and REITs.

In this Ruling, the Service concluded that the inclusion of the income resulting from Taxpayer being a shareholder in controlled foreign corporations and shareholder of a passive foreign investment companies would be treated as qualifying income for purposes of Section 856(c)(2) because such income did not interfere or impede the policy objectives of Congress.

The Service also ruled that the income that Taxpayer had to recognize under Section 956 as a result of the fact that assets of one of its controlled foreign corporations were pledged as collateral for certain debt of Taxpayer would also be considered qualifying income under Section 856(c)(2). This decision was based on the fact that the debt was incurred to finance Taxpayer’s acquisition of real estate assets.

E. Priv. Ltr. Rul. 201119003 (January 12, 2011). Decedent and his second spouse established a revocable family trust. The family trust agreement provided that, on Decedent’s death, the trustees of family trust would create both an exempt trust and a marital trust. Decedent died. As a result, the family trust became irrevocable, the exempt trust was funded with cash in an amount equal to Decedent’s generation-skipping transfer tax exemption remaining at death, and the marital trust was funded with the balance of the family trust assets, after certain mandatory distributions and the payment of certain expenses. On a timely filed estate tax return, Decedent’s estate made a qualified terminable interest property (QTIP) election for the assets distributed to the exempt trust and the marital trust.

More than two years after Decedent’s death, a dispute over the management of certain assets arose between the surviving spouse and her stepchildren. As a result of court-ordered mediation, a settlement agreement was executed. The settlement agreement provided that the marital trust would purchase, at fair market value, from Decedent’s children interests in certain entities owned by both the marital trust and the Decedent’s children so that the marital trust would own 100% of such entities. Similarly, Decedent’s children would purchase, at fair market value, from the marital trust interests in certain entities and real property owned by both the marital trust and the Decedent’s children so that Decedent’s children would own 100% of such entities and properties. Two separate commercial appraisers would be engaged to determine the fair market value of the properties at issue. To the extent that there was any difference in the aggregate fair market values of the purchases, an equalizing payment would be made.

The marital trust requested a ruling that the exchange would not constitute a gift subject to tax under Section 2511 and would not constitute a disposition under Section 2519. Because the exchange was the result of a bona fide adversarial proceeding and would be made for adequate and full consideration as set forth in the appraisals, the Service concluded that the transfers were not subject to gift tax. In addition, because, at the conclusion of the exchange, the surviving spouse would continue to possess a qualifying income interest for life in the assets of the marital trust and her right to income would not be diminished or relinquished, the Service
determined that the sale and purchase of the ownership interests would not be treated as a disposition of a qualifying income interest life under Section 2519.

F. Priv. Ltr. Rul. 201122003 (February 9, 2011). A Trust, which elected to be treated as an electing small business trust (“ESBT”), held stock in an S corporation. The Trust had a number of income beneficiaries. The Trust wanted each income beneficiary’s share in the Trust to be treated as a separate trust. This would allow each income beneficiary the opportunity to file a qualified subchapter S trust (“QSST”) election and revoke the ESBT election applicable thereto without terminating the ESBT election for those income beneficiaries who chose not to make a QSST election. The Service ruled that each income beneficiary’s share of the Trust constituted a separate and independent share of the Trust under Section 663(c) and could qualify as a QSST. As a result, the election by an income beneficiary to revoke the ESBT election applicable thereto and make a QSST election would have no effect on the current ESBT election for the separate shares of the remaining income beneficiaries.

G. Priv. Ltr. Rul. 201122006 (March 1, 2011). Taxpayer, a publicly traded REIT, brought a claim for just compensation for property that was taken by State. State paid Taxpayer an initial amount which Taxpayer elected to treat as an advance payment while it pursued its claim. Taxpayer invested the initial amount into real estate. Subsequently, a court issued an opinion requiring State to pay Taxpayer an additional amount of funds for its property taken by State. The issue of this Ruling was whether the income received by Taxpayer by State would affect Taxpayer’s ability to fulfill the income and assets requirements to qualify as a REIT under Section 856(c). In determining its conclusion, the Service reviewed two Revenue Rulings, Rev. Rul. 64-247, 1964-2 C.B. 179, and Rev. Rul. 74-248, 1974-1 C.B. 167. In both these Rulings, a real estate investment company received certain income as a result of an adversarial action. At the time the Rulings were published, the amounts received were not considered income from sources described in the applicable Code Section. Nevertheless, the Rulings held that the companies’ inclusion of the recovery amounts in gross income did not cause the companies to fail definitionally. Although the Service acknowledged that the Revenue Rulings were declared obsolete, it felt that they remained instructive in determining how certain payments could be treated for REIT qualification purposes. Because Taxpayer represented that it did not engage in any active business activity to create the claim at issue, that the claim was for real estate taken by Taxpayer by State and that it would use the monies to invest into “real estate assets”, the Service ruled that the monies received by Taxpayer from State would not be considered in determining whether Taxpayer satisfied the REIT assets and income test under Section 856(c).

H. Priv. Ltr. Rul. 201132017 (May 10, 2011). Prior to Decedent’s death, Decedent and Surviving Spouse consulted an attorney for estate planning advice and, as a result, created a By-Pass trust, a Survivor’s Trust and a Marital Trust. A provision of the By-Pass Trust agreement provided that, on the death of the Surviving Spouse, the trustee would pay certain expenses and charge them against property in the By-Pass Trust. After consulting with an attorney who confirmed that the charges should have been charged against the Survivor’s Trust and the reference to the By-Pass Trust was a scrivener’s error, Surviving Spouse filed a petition with the court seeking authorization to modify the Trust nunc pro tunc. The concern was that the Trust agreement, as drafted, would provide Surviving Spouse with a testamentary general power of appointment under Section 2041(b)(1) resulting in the possibility that the assets of the By-Pass Trust would be included in the gross estate of Surviving Spouse. The court issued an Order
granting the petition for modification. Surviving Spouse requested a ruling that the By-Pass Trust, as modified, did not provide Surviving Spouse with a testamentary general power of appointment under Section 2041 over the assets of the Trust; the modification of Trust was not an exercise or release of a general power of appointment under Section 2514(b) that constituted a gift for Federal gift tax purposes; and the Surviving Spouse was not deemed to have made a gift under Section 2501 of an interest in a Trust as a result of the Order modifying the Trust agreement.

Based on the fact that the modification of the trust instrument nunc pro tunc because of a scrivener’s error was consistent with applicable law of the State, the Service ruled that modification of the Trust pursuant to a Court’s Order did not provide Surviving Spouse with a general power of appointment, would not constitute the exercise or release of a general power of appointment under Section 2514(b), and would not be treated as a deemed transfer of an interest in a trust by Surviving Spouse for gift tax purposes.

I. Priv. Ltr. Rul. 201135002 (May 17, 2011). Taxpayer, a corporation that intended to qualify as a REIT under Section 856, was a non-publicly traded entity. Because non-publicly traded REITs are often criticized due to their lack of liquidity and their advisory fees based on cost of assets rather than performance, Taxpayer proposed to adopt a multi-class structure. Taxpayer intended to issue two different classes of shares of stock: retail shares and institutional shares. The retail shares would bear a selling commission and dealer manager fee equal to a certain percentage of the gross proceeds of Taxpayer’s primary offering. The institutional shares would bear an annual distribution fee equal to a certain percentage of the net asset value of such shares.

Taxpayer also intended to institute a distribution reinvestment plan. The purchase price per share under the plan would be equal to Taxpayer’s net asset value per share. Taxpayer would also pay an annual advisory fee based on performance calculated on the basis of Taxpayer’s total return to stockholders.

The issue of this Letter Ruling was whether the issuance of two classes of common stock with different distribution fees would cause the dividends not to qualify for the dividends paid deduction under Section 561. In making its decision, the Service relied upon Rev. Proc. 99-40, 1999-2 C.B. 565, which describes conditions under which distributions made to shareholders of a regulated investment company (“RIC”) may vary and nevertheless be deductible as dividends. One of the conditions includes variations resulting from certain allocations of fees and expenses. Although the Service recognized that Taxpayer (as a REIT) was not within the scope of Rev. Proc. 99-40, it felt that the similarity between RICs and REITs afforded them similar treatment in many situations. Consequently, because the difference in distributions was consistent with Rev. Proc. 99-40, the Service concluded that Taxpayer’s distributions on its two classes of stock would not be considered “preferential” dividends, and thus would not cause the Taxpayer to fail to qualify as a REIT.

VIII. CHIEF COUNSEL ADVICE AND TECHNICAL ADVICE MEMORANDA

A. Chief Counsel Advice 201049026 (September 23, 2010). The issue presented in this Advice was whether a house that operated as an adult home care business qualified as
residential rental property, thereby allowing it to be depreciated over a 27½-year recovery period. Specifically, Taxpayers provided general care for adults who could not live on their own (the “Residents”). The Residents lived full-time in the Taxpayers’ home. Each Resident paid Taxpayers $3,000 per month, of which approximately $1,000 was allocated to rent, with the remaining allocated to services that Taxpayers provided to the Resident. To qualify as residential rental property, Section 168(e)(2) provides that at least 80% of the gross rental income from such building must be rental income from dwelling units. Under Section 168(e)(2)(A)(ii)(I) and former Section 167(j)(2), the Service concluded that the bedroom units which Taxpayers rented to Residents qualified as dwelling units under Section 168(e)(2). For purposes of applying the 80% test, the Service concluded that the $2,000 per month allocated to the services provided by Taxpayers did not constitute gross rental income because such services were not customarily rendered in connection with the mere rental of rooms. As a result, the Service concluded that 100% of the gross rental income was considered rental income from dwelling units. Accordingly, the portion of the house leased as dwelling units to the Residents could be depreciated over a 27½-year recovery period. It should be noted that the Advice specifically stated that it did not address whether Section 280A limited the Taxpayers’ deductions.

B. Chief Counsel Advice 201111006 (March 18, 2011). Taxpayer and its customers entered into “term agreements” that required Taxpayer to design and develop certain manufactured items. The agreements also set forth terms for sale of the components when the customer submitted a purchase order. Taxpayer was not obligated to provide the customer with the manufactured item before a purchase order was submitted. The issue presented in this Advice was whether Taxpayer’s design and development costs, which included certain research and experimental costs described in Section 174 (the “Research Costs”), would be allocable to one or more long-term contracts entered in a future year so as to require capitalization as “pre-contracting year costs”. Because the Research Costs were incurred in designing and developing the items and would directly benefit any long-term contract for the manufacture and delivery of such items, the Service stated that such costs had to be capitalized as “pre-contracting year costs”. The Research Costs only became deductible when Taxpayer became obligated to manufacture and provide the item under the purchase order.

C. Technical Advice Memorandum 201035016 (June 3, 2010). Taxpayers collectively owned a 99% limited partner interest and a 1% general partner interest in a limited partnership that developed nursing homes. Taxpayers determined that they materially participated in the nursing homes from 1990 through 1994 and, accordingly, treated the majority of losses that flowed through the partnership as not being subject to the passive loss rules under Section 469. On audit, the Examiner took the position that Taxpayers did not materially participate in the nursing home activity in 1994 and requested guidance with respect to whether a recharacterization of Taxpayers’ activities from non-passive to passive was considered a change in accounting methods requiring a computation adjustment under Section 481(a). Because the determination of whether an activity is passive or non-passive does not determine the period into which an item of income or deduction will be placed, the Service ruled that such determination is not a change in method of accounting. It should be noted that the Service recognized that Congress placed Section 469 in the part of the Code entitled “Methods of Accounting”, but stated that it did not believe that the legislative history indicated that such treatment is “as significant as [the Examiner] would have us believe”.

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D. Technical Advice Memorandum 201111004 (December 13, 2010). The issue raised in this Technical Advice Memorandum is whether inventory that is involuntarily converted in a Presidentially declared disaster is considered property held for productive use in a trade or business for purposes of Section 1033(h). The short answer is yes. More specifically, Taxpayer’s business units were damaged by the 2006 Gulf Coast hurricanes. It received insurance and salvage proceeds relating to property involuntarily converted as a result of the hurricanes. Taxpayer reinvested most of the insurance and salvage proceeds in new construction property and reduced the basis of the new property by the amount of the deferred gain. Taxpayer expected to reinvest the remaining proceeds in a timely manner. Taxpayer had purchased and sold inventory since the hurricanes but had not designated any acquired inventory as replacement property for the inventory destroyed.

Section 1033(h)(2) provides that, if a taxpayer’s property held for productive use in a trade or business or for investment is located in a disaster area and is compulsorily or involuntarily converted as a result of a Presidentially declared disaster, then tangible property held for productive use in a trade or business is treated as property similar to the converted property. Several Code provisions, such as Section 1031(a), relating to deferral of gain explicitly disallow deferral for dispositions of inventory. However, Section 1033(h)(2) does not contain any specific language related to inventory, stock in trade or property held primarily for sale. Because the Service believed that Congress knew “how to make clear distinctions between inventory and other forms of business and investment property”, and did not exclude conversions of inventory from Section 1033(h)(2) application, it stated that Section 1033(h)(2) applied to inventory that was involuntarily converted in a Presidentially declared disaster.

E. Associate Chief Counsel Memorandum 2010-007 (December 23, 2010). Section 179D provides a deduction for part or all of the costs of certain energy efficient commercial building property. With respect to property that is owned by a governmental agency or political subdivision, Section 179D allows the person who is primarily responsible for designing the property (i.e., the “designer”) to claim the deduction. This Memorandum focuses on the application of the Section 179D deduction to partnership and S corporation “designers”. Specifically, it concludes that: (1) partners or shareholders of the designer are required to reduce the adjusted bases in their partnership interest or S corporation stock by the amount of the Section 179D deduction, and (2) the provisions of Sections 704(d) and 1366(d) limit the benefit of the Section 179D deduction to the partners’ or shareholders’ adjusted bases in their partnership interests or S corporation stock.

The Memorandum recognizes that, in certain scenarios, partners and S corporation shareholders may claim deductions directly; however, in those circumstances, there is explicit authority providing for such a result, and such authority does not exist in Section 179D. As a result, the Section 179D deduction is utilized to calculate the entity’s ordinary income or loss, and each partner/shareholder’s share of that income or loss, requires an adjustment to the partner/shareholder’s basis in its ownership interest under Sections 705(a) and 1367(a), and the partner/shareholder’s ability to claim any ordinary loss generated by the deduction is limited to such partner/shareholder’s basis in his, her or its ownership interest under Sections 704(d) and 1366(d).
IX. CASES

A. Estate of Adler v. Comm’r, T.C. Memo 2011-28. Axel O. Adler died in 2004. Before December 8, 1965, Mr. Adler owned property in Carmel, California which consisted of approximately 1,100 acres at the date of his death. The property was known as the Rancho Aguila property. On December 8, 1965, Mr. Adler executed a grant deed transferring an undivided one-fifth interest in the Rancho Aguila property to his five children. The deed, however, stated that Mr. Adler “[reserved] unto himself the full use, control, income and possession of … [the Rancho Aguila property] and every part thereof for and during… [his] natural life.” The transfer was gratuitous. In 1991, Mr. Adler’s daughter executed a quitclaim deed transferring her interest back to Mr. Adler, but neither recorded the deed. Litigation over her interest occurred during probate of Mr. Adler’s estate. As a result, the daughter executed a deed transferring her interest in the Rancho Aguila property to the estate. At the time of Mr. Adler’s death, the fair market value of a fee simple interest in the entire Rancho Aguila property was $6,390,000.

The issue was whether the value to include in the gross estate was the undiscounted value of a fee simple interest in the Rancho Aguila property or the value of several fractional interests in the Rancho Aguila property, which would be valued separately with appropriate fractional-interest discounts. Relying on Sections 2033 and 2036 which provide that the value of a gross estate includes the value of property as to which the decedent retained for his life the possession or enjoyment of the property, the Court found Mr. Adler retained a life estate in the property and transferred a one-fifth remainder interest to each of his five children at his death. Accordingly, the Court found that value included in the gross estate was the undiscounted value of $6,390,000.

B. Alphonso v. Comm’r, 136 T.C. No. 11 (2011) Ms. Alphonso owned shares of stock in a cooperative housing corporation which owned a tract of land in New York. Ms. Alphonso lived in the apartment to which the cooperative housing corporation had allocated her shares of stock and with respect to which she executed a lease. In 2005, a retaining wall which separated the housing complex from the public road collapsed, causing significant damage. The cooperative levied an assessment against each stockholder. Ms. Alphonso’s assessment equaled $26,390. On her 2005 tax return, she claimed a casualty loss in the amount of her assessment and a casualty loss deduction of $23,188 (taking into account the reductions required by Section 165(h)).

The issue was whether Ms. Alphonso was entitled to a casualty loss deduction. The Court reviewed West v. U.S., 163 F. Supp. 739 (E.D. Pa. 1958), aff’d 259 F.2d 704 (3rd Cir. 1958), where the taxpayer was a member of an incorporated social club that owned land which included a dam. The taxpayer leased from the corporation under a 99-year lease a lot on which the taxpayer built a cottage. A hurricane destroyed the dam and the corporation levied an assessment against each member of the social club. The U.S. District Court for the Eastern District of Pennsylvania held that the taxpayer had no property interest in the dam and thus was not entitled to a deduction.

The Court decided that Ms. Alphonso’s situation was similar to that of the taxpayer in West and, therefore, held that she was not entitled to a casualty loss deduction.
C. Anyika v. Comm’r, T.C. Memo 2011-69. Mr. Anyika was an engineer and worked in such position 1,800 hours per year. He was also involved in purchasing, managing, renovating and selling rental properties and viewed his real estate activity both as a “second job” and an investment. The Anyikas used TurboTax software to prepare their tax returns and deducted their rental real estate losses. On audit, the Service disallowed almost all of their rental real estate loss deductions. After receiving the Service’s notice of deficiency, the Anyikas timely petitioned the Court. However, the Anyikas failed to provide an answer to the Service’s interrogatories and to turn over requested documents, in spite of the Court’s order compelling such actions.

At trial, Mr. Anyika declared, under penalties of perjury, that he devoted 800 hours a year to his rental real estate activities and thus qualified as a real estate professional under Section 469(c)(7)(B). After the Court explained that, to qualify as a real estate professional, he had to spend more hours engaged in managing the rental properties than he did working as an engineer, Mr. Anyika contended that he spent 1,920 hours working on the rental properties. The Court did not look favorably upon his testimony and concluded that his activities were passive in nature because he did not qualify as a real estate professional.

However, the Court did examine whether the Anyikas were eligible to deduct a portion of the real estate losses under Section 469(i)(1) because of Mr. Anyika’s active participation in managing the rental properties. Because the Service conceded that Mr. Anyika actively participated in his rental real estate properties and the record demonstrated this fact, the Court held in favor of Mr. Anyika and allowed the deduction, subject to the phase-out rules.

In addition to imposing substantial understatement penalties, the Service moved for sanctions, under Section 6673(a)(1), against the Anyikas for failing to cooperate with the Service’s request for documents. The Court held the Anyikas liable for penalties under Section 6662 because of a substantial understatement (in 2005) and for acting negligently (in 2006), resulting from Mr. Anyika’s failure carefully to document the hours he worked on the rental properties and failure to consult a tax professional, even though he acknowledged at trial that he misunderstood the relevant statute and that the law governing the deduction was complex. However, the Court did not hold the Anyikas liable for penalties under Section 6673(a), for instituting proceedings primarily for delay and for having a frivolous or groundless position. The Court recognized that, although Mr. Anyika was uncooperative and failed to reply to the Service’s requests for documents, it did not believe this delay was purposeful but instead was based on “negligent disorganization”.

D. Bailey v. Comm’r, T.C. Summary Opinion 2011-22. For 2004, Ms. Bailey operated three rental properties that she owned jointly with her husband. One of the rental properties was an inn which was usually rented for approximately three days at a time. The other two rental properties were leased to year-to-year tenants. On their 2004 tax return, the Baileys deducted a loss of approximately $20,000 from the inn and a loss of approximately $17,000 from the other two rental properties. The sole issue was whether Ms. Bailey qualified as a real estate professional under Section 469(c)(7) and thus was able to deduct the $17,000 loss from the two rental properties. The Service conceded that Ms. Bailey materially participated in the inn, and so allowed the loss attributable to that property. However, it stated that the losses from the other two properties were passive activity losses.
The Service asserted that Ms. Bailey was not a real estate professional because she failed to satisfy the 750-hour requirement. Specifically, the Service stated that the inn was not a “real property trade or business” under Section 469(c)(7) because its average use was less than 7 days and thus Ms. Bailey could not include the hours spent in managing the inn for purposes of calculating the 750-hour requirement. On the other hand, Ms. Bailey contended that the plain language of Section 469(c)(7)(C) and its legislative history allowed her to include all real property trades or businesses in which she materially participated during the year for the purpose of computing the 750-hour requirement and thus was able to include the hours she worked at the inn.

After reviewing Bailey v. Comm’r, T.C. Memo 2001-296 (no relation to taxpayers), where the Court held that the taxpayer could not combine her hours on rental property A with rental properties B and C because the rental period for property A was less than the 7-day threshold, the Court held in favor of the Service. Ms. Bailey tried to distinguish her situation from Bailey based on the fact that, unlike the taxpayer in Bailey, she materially participated in the inn. However, the Court stated that, in this situation, because the average period of use of the inn was less than 7 days, the rental of the inn was not considered a “rental activity”, and so Ms. Bailey could not include the hours expended in renting out the inn for purposes of satisfying the 750-hour requirement, regardless of whether she materially participated in the activity.

E. Boltar, L.L.C. v. Comm’r, 136 T.C. No. 14 (2011). In this case, the Service moved to exclude taxpayer’s expert’s appraisal report (the “Integra Report”) as unreliable and irrelevant. The Court agreed with the Service and concluded that the Integra Report was not admissible, because it was not the product of a reliable method, resulting from the fact that it assumed scenarios that were unrealistic.

In 1999, LLC quitclaimed to Boltar certain parcels of Land (“the N and S Parcels”) to prevent foreclosure. LLC paid $100,000 for the N and S Parcels in 1996. In 2002, Land Trust, an independent entity, quitclaimed to Boltar approximately 10 acres of real property located adjacent to the N and S Parcels. In 2003, Boltar granted Land Trust an easement restricting the use of approximately 8 acres of property located on the eastern side of the N and S Parcels. On its 2003 tax returns, Boltar claimed a charitable contribution deduction of approximately $3.2 million for the easement. Boltar attached the Integra Report to its tax return, along with an IRS Form 8283, “Noncash Charitable Contributions”. The Integra Report determined that the “highest and best use” of the property was residential development and determined the easement value based on the difference between the foregone development opportunity of 174 condominiums on the finished sites and the value of raw vacant and developable land.

The Service issued LLC a Final Partnership Administrative Adjustment (“FPAA”), which stated that the fair market value of the easement was $42,400. The Service’s valuation engineer opined that the “highest and best use” of the property was for development of single-family detached residential homes, but not until the surrounding area was developed, because the parcel was landlocked with no direct access to public roads.
Prior to trial, the Service moved to exclude the Integra Report as neither reliable nor relevant. It asserted that taxpayer departed from the legal standard to be applied in determining the highest and best use of the property, and instead determined the value “based on whatever use generate[d] the largest profit….without regard to whether such use [was] needed or likely to be needed in the reasonably foreseeable future”.

In reaching its conclusion, the Court stated that it viewed trial courts as “gatekeepers” to “increase the efficiency of trials and the objectivity of judgments”. And “[i]n this case, in the view of the trial Judge, the expert report [was] so far beyond the realm of usefulness that admission [was] inappropriate and exclusion serve[d] salutary purposes”. The Court stated that the Integra Report did not determine the highest and best use of the property after the easement was granted by considering the potential for single-family residential development. In addition, the Integra Report did not consider the effect of the easement on contiguous property owned by taxpayer because, according to the Court, “the writers were unaware of the extent of [taxpayer’s] ownership”. Moreover, when the Service pointed out to the taxpayer that its site plan for the condominiums was based on 10 acres when the property at issue was only 8 acres and the fact that the Integra Report ignored the effect of a preexisting utility easement which would preclude the construction of several condominium buildings, the Court stated that the taxpayer’s only response was that “the project ‘will fit, it just won’t fit as drawn’ on the site plan”. Taxpayer did not refute any of the Service’s specific objections to the Integra Report and did not suggest any quantitative adjustments in response to their admitted errors. As a result, the Court concluded that the Integra Report was not admissible and that there was no evidence that justified a value higher than the amount determined in the FPAA.

F. Estate of Coaxum v. Comm’r, T.C. Memo 2011-135. At the time of his death, Decedent had six life insurance policies in force (with a value of approximately $1.2 million) and owned annuities with a value of approximately $470,000. Decedent died in 2003. His brother, the executor of the estate, did not file an estate tax return until 2006. The estate tax return reported the fair market value of the insurance policies in the gross estate of Decedent; however, it excluded the entire value of the annuities.

The Service issued a notice of deficiency which stated that the annuities valued at $470,000 should be included in Decedent’s gross estate and slightly reduced the value of the insurance policies. In the petition, the estate further claimed that the value of the insurance policies should be excluded from Decedent’s gross estate. Because Decedent retained the right to change the beneficiaries on the life insurance policies until his death, the Court ruled that the policies were included in the gross estate under Section 2042. With respect to the annuities, the estate argued that they should be excluded from the gross estate because the Decedent’s beneficiaries would be allowed a deduction in the amount of Federal estate tax paid on the IRD items. (This refers to the fact that the value of the annuities was reported as taxable income on Decedent’s brother’s 2004 and 2005 Federal income tax returns.) Stating that it did not have jurisdiction to determine the income tax liability of Decedent’s brother, the Court ruled that the value of the annuities owned by the estate were included in the value of Decedent’s gross estate under Section 2039(a). Finally, the Court sustained the Section 6651(a)(1) penalty for failure to file a return on a timely basis. The estate failed to provide that the return was not filed due to a reasonable cause instead of willful neglect.
G. Crandall v. Comm’r, T.C. Summary Opinion 2011-14. Taxpayers owned an undeveloped parcel of property in Arizona and decided to exchange it for property closer to their California residence. Taxpayers sold the Arizona property for $76,000. The buyers paid the Taxpayers $10,000 and the remaining $66,000 was placed in an escrow account. The escrow agreement did not restrict Taxpayers’ access to and use of the funds held in the escrow account. In addition, the escrow agreement did mention a like-kind exchange. Although Taxpayers intended to have the exchange qualify for Section 1031 treatment, the Court concluded that the lack of express limitations in the escrow agreement resulted in Taxpayers being treated as having constructively received the proceeds. Consequently, the exchange did not qualify for Section 1031 treatment.

H. Dagres v. Comm’r, 136 T.C. No. 12 (2011). Taxpayer was a salaried employee and shareholder of a venture capital management company (“Battery Ventures”). He also served as a member-manager of the general partner of the venture capital fund. Taxpayer earned income in three different ways: (1) as an employee of Battery Ventures, he received a salary; (2) as a stockholder of Battery Ventures, he was entitled to receive his proportionate share of any service fees paid to Battery Ventures by the capital venture fund; and (3) as a member-manager of the general partner of the venture capital fund, he was entitled to a proportionate share of the carried interest (a 20% profits interest that each venture fund paid to its general partner).

Before joining Battery Ventures, Taxpayer had helped PSINet go public. PSINet’s chairman and chief executive, Mr. Schrader, reconnected with Taxpayer when he learned he moved to Battery Ventures. Mr. Schrader was an early pioneer of the commercial internet, and Taxpayer found him to be an influential and useful contact. Mr. Schrader was “an important source of leads on promising companies” for Taxpayer. When the internet stock bubble burst in 2000, PSINet hit hard times. After exhausting his personal funds and the money he could obtain from friends and family, Mr. Schrader asked Taxpayer to lend him $5 million.

With the hopes of strengthening his relationship with PSINet and Mr. Schrader, Taxpayer made a $5 million unsecured loan with interest above the AFR. It was understood that, in return for the loan, Mr. Schrader would tell Taxpayer any information he learned about promising companies before anyone else.

Mr. Schrader repaid $800,000, but then his financial condition worsened. To avoid Mr. Schrader filing for bankruptcy protection, Taxpayer forgave the original loan in exchange for a new non-demand promissory note for $4 million with interest.

Mr. Schrader made $30,000 in payments, but then he notified Taxpayer that he could not make any further payments. Taxpayer and Mr. Schrader executed a settlement agreement to which Taxpayer accepted approximately $400,000 in securities in exchange for the forgiveness of the remaining balance on the note.

On his tax return, Taxpayer claimed a business bad debt loss in the amount of approximately $3.6 million (the difference between the $4 million principal amount of the loan and the agreed value of the securities). The Service issued Taxpayer a notice of deficiency claiming that the debt was a non-business bad debt because it was a personal loan. The Court held in favor of Taxpayer because it found that Taxpayer’s dominant motivation for lending the
$5 million was to gain “preferential access to companies and deals to which Mr. Schrader might refer him”. This information, in turn, could be used in Taxpayer’s venture capital activities that he undertook as the member manager of the general partner of the venture capital funds. It also stated that his loan was related to his personal intention to obtain a “carried interest” from the general partner of the capital venture funds. As a result, the Court felt that the dominant motivation of the loan was business and the bad debt had a proximate relationship to Taxpayer’s venture capital business and to protect his carried interest, not to his salary or his own investment.

I. DiDonato v. Comm’r, T.C. Memo 2011-153. In 1995, Mr. DiDonato purchased two parcels of property in Princeton, NJ. Adjacent to the parcels was a local park owned by the County. The parcels could be accessed by way of a dirt road or by crossing over the land owned by the County. In 1997, the County conveyed to Mr. DiDonato for $1 a 50-foot-wide easement (full driveway) and right of way across the County’s property for pedestrian and vehicular ingress and egress. The easement was recorded in 1997.

At some point thereafter, Mr. DiDonato filed a lawsuit against the County with respect to the deed of easement, and Mr. DiDonato and the County entered into a settlement agreement to resolve the lawsuit. Under the terms of the settlement agreement, the County agreed to convey a portion of the driveway to Mr. DiDonato in fee simple, and Mr. DiDonato agreed to limit his use of the parcels to a single family residence. The County sent to Mr. DiDonato a letter acknowledging and thanking him for his “donation” of the development rights to the parcels. That letter advised Mr. DiDonato that the County did not independently appraise the donated property and that it was Mr. DiDonato's responsibility to determine the value of the donated property for “income tax deductibility” purposes.

On their tax returns, the DiDonatos claimed a charitable contribution deduction related to the easement contribution and attached a Form 8283, “Noncash Charitable Contributions”, on which they reported the appraised fair market value of the land conservation easement as $1,870,000 and their cost or adjusted basis as $300,000. The Form 8283 was not signed by an appraiser or an authorized representative of the county. Petitioners also attached to their 2004 return a Self Contained Complete Appraisal Report (appraisal) prepared by Tighue Appraisal Group (Tighue). The Service claimed that the DiDonatos were not entitled to deduct any part of the $1,870,000 charitable contribution.

The issue before the Court was whether the DiDonatos substantiated the reported charitable contribution in the manner required under Section 170(f)(8). The Service argued that the DiDonatos failed to obtain a contemporaneous written acknowledgment of the donated property as required by Section 170(f)(8) and did not attach to their 2004 return a completed appraisal summary (i.e., Form 8283) as required by Reg. §1.170A-13(c)(2). The DiDonatos argued that the settlement agreement qualified as a contemporaneous written acknowledgment under Section 170(f)(8), and that the Form 8283 which they attached to their income tax return substantially complied with the requirements of Reg. §1.170A-13(c)(2).

The Court agreed with the Service. Finding that neither Congress nor the Service defined the term “acknowledgment” and that there had not been a reported decision interpreting the term “acknowledgment”, the Court looked at the reason behind the enactment of Section

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170(f)(8) and concluded that the settlement agreement did not qualify as an “acknowledgment” under Section 170(f)(8). Mr. DiDonato argued that the settlement agreement qualified as a contemporaneous written acknowledgment because it legally obligated Mr. DiDonato to donate his development rights in the parcels. The Court did not agree because it believed that the rights and obligations under the settlement agreement were “subject to and conditioned upon” certain county approvals.

J. Ellington v. Comm’r, T.C. Memo 2011-193. Taxpayers financed their personal residence with a loan from Merrill Lynch Credit Corp. (the “Merrill Loan”), which was secured by the Taxpayers’ personal residence and 8,750 shares of Intel stock. Taxpayers refinanced the Merrill Loan with a second loan (the “ABN Loan”). The ABN Loan was secured solely by their personal residence. Taxpayers deducted a portion of their interest accrued on the Merrill Loan and the ABN Loan as investment interest. The Service disallowed the deductions.

Taxpayers argued that they could deduct interest accrued on the Merrill Loan and ABN Loan as investment interest, to the extent such interest was attributable to the Intel stock and was not qualified residence interest. The Court disagreed.

The Court reviewed Section 163 and the underlying Regulations and stated that the “use” of the debt proceeds determines whether any portion of the indebtedness is allocable to investment property. In this case, all of the loan proceeds were allocated to the Taxpayers’ personal residence. Thus, the use of the Intel stock to secure repayment of indebtedness had “no effect on the allocation of debt and interest”. As a result, the Court held the interest accrued on the Merrill Loan and ABN Loan was not considered investment interest.

K. Evans v. Comm’r, T.C. Memo 2010-207. Taxpayers granted façade easements on two buildings to Capital Historic Trust, Inc. On their 2004 tax return, they claimed a $154,350 charitable contribution deduction attributable to the façade easements. In 2008, the Service issued Taxpayers a notice of deficiency claiming that the charitable contribution deduction was not allowable. The Service argued that Taxpayers failed to satisfy the substantiation requirement of Section 170(f).

At trial, Taxpayers called Sandy Lassere (“Lassere”), who prepared appraisal reports with respect to the façade easements. The appraisal reports were signed in 2008. The Court felt that Lassere’s report revealed that she merely applied a percentage discount to the respective property’s before-donation market value to account for the grant of the façade easement. Moreover, at trial, Lassere admitted to making mistakes in her prepared report, committing numerous miscalculations, and making improper size adjustments with respect to sales of comparable properties. As a result, the Court sustained the Service’s denial of the deduction. It should be noted that Lassere’s approach was similar to the approach taken by the appraiser in Scheidelman v. Comm’r, T.C. Memo 2010-151, which also resulted in the taxpayer’s disallowance of a charitable deduction for her façade easement contribution.

Taxpayers had two other appraisers prepare reports with respect to the façade easements. Such reports appeared to be used by Taxpayers in preparing their 2004 tax returns and one appraiser signed Part III of each of the Form 8283s. Although the Court stated that it was precluded from considering these reports as evidence of the fair market value of the façade easements, the Court found that the Taxpayers had satisfied the substantiation requirement of Section 170(f), and the Service’s disallowance of the charitable contribution deduction was reversed.
easements because the appraisers were not called to testify, it did allow the appraisal reports to be considered for purposes of determining whether Taxpayers were liable for penalties under Section 6662. In this instance, the Court felt that the appraisals satisfied the requirements of Reg. § 1.170A-13(c), even though the Service believed there was no “meaningful explanation for the valuation arrived at” and that each appraiser simply used an 11-percent discount applied to the before-donation market value. The Court felt that the Service could have called the appraisers as witnesses and questioned them on their methodology, as in Scheidelman. Because of this fact, the Court ruled that the Service failed to carry its burden of demonstrating that the charitable contribution deduction was not based on a qualified appraisal and denied the imposition of the penalty. (In this case, the Service bore not only the burden of production but also the burden of proof with respect to the penalty because it asserted the penalty in its answer but not in the notice of deficiency.)

L. Estate of Gallagher v. Comm’r, T.C. Memo 2011-148. At her death, Decedent owned 3,970 membership units in PMG, a company that engaged in print media. On the estate tax return, the membership units were valued at $34,936,000, based on an appraisal by PMG’s President and CEO. The Service issued a notice of deficiency, which asserted that the fair market value of the units was $49,500,000.

Before the start of the trial, the estate of Decedent hired another appraiser, who valued the units at $28,200,000, and the Service hired an appraiser who valued the units at $40,863,000. The issue before the Court was the fair market value of Decedent’s membership unit in PMG. The Service’s expert valued the units using both a market approach and an income approach. He applied a 17% minority interest discount to the value under the income approach and a 31% lack of marketability discount to the values under both approaches. The estate’s appraiser relied primarily on the income approach to value Decedent’s units, using the market approach only to establish a reasonable estimate of fair market value. He applied a 30% lack of marketability discount.

The Court discussed each appraisal report and the areas of disagreement, including the propriety of relying on a market-based valuation approach in valuing the units, the application of the discounted cash flow method, and the size of applicable discounts. With respect to the reliance on a market-based approach (specifically, the use of the guideline company method which estimates the value of a subject company by comparing it to similar public companies), only the Service’s expert relied upon this method for valuing Decedent’s units. The estate felt such reliance was improper because of the lack of companies sufficiently similar to PMG to support the method’s application. The Court agreed with the estate because it felt that PMG was smaller and had a different business product and a greater revenue growth than the four guideline companies discussed in the Service’s appraiser’s report.

Because of the lack of public companies, the Court believed that the discounted cash flow method was the most appropriate method with which to value the units. Although both appraisers used this method, their valuation computation methods were different. To determine the value, the Court discussed in detail each expert’s computation and compared all aspects of the reports, including revenue growth projections, operating income, the impact of taxes on PMG’s earnings and cash flow adjustments. In some instances, it resolved disputes in favor of the Service, and in others, in favor of the estate.
Although both parties agreed that it was appropriate to take into account a minority interest and lack of marketability discount, they differed on the size of the discounts and, with respect to the minority interest discount, the method of application. The Service’s expert applied a 17% minority interest discount and then applied a 31% lack of marketability discount. The estate’s expert applied a 30% lack of marketability discount because he believed the discounted cash flow methodology was adjusted to reflect a minority interest value.

The Court agreed with the Service’s expert that there should be a separate minority interest discount and determined that a 23% minority interest discount to the equity value of PMG computed on a 30% controlling interest basis under the discounted cash flow method was appropriate. In addition, the Court determined that a 31% lack of marketability discount was appropriate based on the restrictive nature of the stock (i.e., there was a shareholder agreement in existence). Based on these findings, the Court determined that the value of the units was $32,601,640, which was actually less than the amount reported on the estate tax return.

M. Gardner v. Comm’r, T.C. Memo 2011-137. Over a 26-year period, Taxpayer bought and sold 16 parcels of real property. In general, Taxpayer would buy unimproved land, build a single family residence and immediately sell the improved property. In certain instances, he would buy unimproved land, build a multi-family housing building and keep the building for rental income purposes. In 2004, Taxpayer purchased from his brother and sister-in-law property which had been approved for subdivision into 5 lots. He built a road on the lots. Taxpayer testified that his intention was to keep the lots and use them for investment purposes; however, because the cost of the roadway was high, he sold three of the lots. He reported the gain as short-term capital gains. The Service argued that Taxpayer was a dealer in real properties, thereby recharacterizing the income resulting from the transaction as gain from the sale of property held primarily for sale to customers. Although Taxpayer conceded that he was a dealer, he stated that he was an investor with respect to the lots in questions.

For purposes of determining whether Taxpayer was an investor or dealer, the Court looked at eight factors, including: (1) the purpose for which the property was acquired; (2) the purpose for which it was held; (3) improvements made to the property by Taxpayer; (4) the frequency, number and continuity of sales; (5) the extent and substantiality of the transactions; (6) the nature and extent of taxpayer's business; (7) the extent of advertising to promote sales, or the lack of such advertising; and (8) listing of the property for sale directly or through brokers. Determining that Taxpayer was a credible witness, the Court was convinced that Taxpayer did not intend to include the property in his “build-and-sell” activities, but rather to develop multi-family houses for rental income purposes. As a result, it concluded that Taxpayer appropriately characterized the gain on the sale of the lots as short-term capital gains.

With respect to a different piece of real property, the Service argued that Taxpayer was not allowed to deduct certain expenses (i.e., engineering services, interest and taxes) as ordinary and necessary business expenses under Section 162. The Service stated that such expenses had to be capitalized under Section 263A because they were direct or indirect costs related to the future production (i.e., construction) of the property. Because the Court believed that Taxpayer’s objective was to subdivide the property and sell it, the Court concluded that Taxpayer held the property for production within the meaning of Section 263A. As a result, the engineering services and real estate taxes had to be capitalized. However, because Section
263A does not require interest expenses to be capitalized until physical production activity begins, the Court held that the interest expenses were deductible because there was no physical production during the period at issue.

N. Estate of Giustina v. Comm’r, T.C. Memo 2011-141. Giustina was the trustee of a revocable trust, which owned a limited partner interest in Giustina Land & Timber Co. Limited Partnership (the “LP”). In 1990, the LP was one of three new partnerships formed to which were contributed interests in the assets of two family businesses. The LP was owned by Giustina and his family, as well as his brother and his family and another relative. Giustina died in 2005, at which time he owned a 41.28% limited partner interest in the LP, which owned 47,939 acres of timberland in Oregon.

From the date of formation, the LP was governed by a written partnership agreement, which included a buy-sell agreement that barred a limited partner from transferring an interest in the LP, unless the transfer was to a member of the transferring partner’s “family group”. Giustina’s family group included him, his children and his grandchildren. The buy-sell agreement was in effect at the time of Giustina’s death.

On the estate tax return, the value of the 41.28% limited partner interest was reported to be $12,678,117. The Service issued a notice of deficiency, claiming that the limited partner interest had a value of $35,710,000. However, at trial, the Service contended that the value was $33,515,000 and the estate contended that the value was $12,995,000.

Both the estate and the Service provided expert witnesses as to the value of the limited partner interest. The Court found two methods helpful – the cash flow method (which was based upon how much cash the partnership would be expected to earn if it had continued its ongoing forestry operations) and the asset method (which was based upon the value of the partnership’s assets if they were sold).

With respect to the cash flow method, the Service’s expert valued the total future cash flow, discounted to present value, at $65,760,000 and the estate’s expert valued it at $33,800,000. The Court found that the Service’s expert’s valuation had internal inconsistencies and therefore disregarded it. With regard to the estate’s expert’s valuation, the Court found problems with the application of the cash flow method, but adjusted the computation to arrive at the correct value. Specifically, the Court eliminated a 25% reduction for taxes because the cash flow was based on a pre-tax rate of return (not a post-tax rate of return), and it reduced a 3.5% discount for partnership-specific risks by half. As a result, under the cash flow method, the Court calculated that the value of the LP was $51,702,857. Regarding the discount for lack of marketability, because the estate’s expert did not rebut the Service’s expert’s testimony that he used studies which overstated the discount for lack of marketability, the Court adopted the Service’s expert’s discount of 25%.

With respect to the asset method, the Service’s expert claimed that the total value of the assets of the LP was $150,680,000. Because this valuation was essentially unchallenged by the estate, the Court accepted this valuation. The Court did not feel it was appropriate to apply a discount for lack of control or marketability to the asset method, even though the Service’s expert applied such a discount. Instead, it reflected the “lack of control to cause a sale”
in the weighting of the two methods. For this reason and because the Giustina family had a long history of acquiring and retaining timberlands, it gave a 75% weight to the cash flow method and a 25% weight to the asset method. As a result, the Court held that the value of the limited partner interest was $27,454,115.

O. Goosen v. Comm’r, 136 T.C. No. 27 (2011). Goosen, a professional golfer and UK resident, entered into worldwide endorsement agreements with several sponsors. Goosen agreed not only to allow the sponsors to use his name, face image and likeness in worldwide advertising and marketing campaigns, but also to perform some services for the sponsors. Three of the sponsors (the “On-Course Sponsors”) prorated Goosen’s base endorsement fee if he did not play a minimum number of golf tournaments each year and provided bonuses to Goosen if he achieved certain performance measures.

Several issues were raised in this case. The first issue was whether the endorsement fees and bonuses from the On-Course Sponsors were characterized as personal services income or royalty income. On his tax returns, Goosen characterized the income as 50% royalty income and 50% personal services income. At trial, Goosen argued that the sponsors paid him for the right to co-market and co-brand their products with his name and likeness, and thus the income was royalty income. He also provided an expert report from the former President of Wilson Sporting Goods supporting his assertion. The Service argued that the sponsors paid Goosen to play golf and to carry or wear their products, and thus the income was personal services income. The Court stated the issue depended on whether the On-Course Sponsors primarily paid for Goosen’s services, for the use of his name and likeness, or for both. Because the endorsement agreements granted each On-Course Sponsor the right to use Goosen’s name and likeness for advertising and required Goosen to wear or use such On-Course Sponsor’s products, the Court stated that each On-Course Sponsor paid for both services and Goosen’s name and likeness. Because the endorsement agreements failed to allocate between services Goosen was to provide and the amount paid for the right to use his name and likeness, the Court stated that it would allocate the income equally between these two items. As a result, it held that 50% of the endorsement fees and bonuses from the On-Course Sponsors represented royalty income and 50% represented personal services income.

The next issue raised was what portion of the endorsement income that was considered “royalty income” was sourced to the United States. In general, royalty income is sourced where the property is used or is granted the privilege of being used. Because Goosen established that he owned the rights to his name and likeness outside the United States and that those rights had value, the Court decided to make a reasonable sourcing allocation of the income, even though the parties presented little statistical evidence. With respect to sponsor agreements related to golf cards and video games, the Court used the percentage of product sales in the United States to determine the allocation. With respect to sponsor agreements related to the On-Course sponsors and Rolex, the Court held that 50% of the royalty income was attributable to the United States because the United States was the largest golf market in the world.

The final issue raised was whether the U.S. sourced income was effectively connected with a U.S. trade or business. If Goosen’s U.S. sourced income was effectively connected with a U.S. trade or business, then (as a nonresident alien) he would be subject to graduated tax rates applicable to U.S. residents. If the income was not effectively connected
with a U.S. trade or business, then he would be subject to a flat 30% withholding rate. With respect to the royalty income from the On-Course Sponsors, it held that such income was effectively connected with a U.S. trade or business. With respect to the royalty income from the other sponsors (which did not require Goosen to wear or promote their products on the golf course), it held that the income was not effectively connected with a U.S. trade or business.

P. Harnett v. Comm’r, T.C. Memo 2011-191. Taxpayer owned a significant amount of real estate, which he acquired before the years at issue (2003 through 2005). At one time, he rented out many of the properties, but by 2003, he had mostly stopped renting these properties and had begun trying to sell them. Taxpayer was in his early seventies, in poor health and Chairman of the Board and CEO of a bank during the years at issue.

On his 2003 through 2005 tax returns, Taxpayer deducted losses from his properties. The Service issued Taxpayer a notice of deficiency, claiming the losses were subject to Section 469 limitations because they were attributable to rental activities. Taxpayer contended that he was a real estate professional and thus the losses were not from passive activities.

The Court examined each of Taxpayer’s properties to determine if Taxpayer satisfied the 750-hour requirement necessary to be classified as a real estate professional. Because Taxpayer did not maintain a contemporaneous log of time spent participating in his real estate activities, Taxpayer relied heavily on his testimony at trial to support his argument. The Court found that Taxpayer’s testimony and contemporaneous records were vague, exaggerated and contradicted by other evidence that Taxpayer offered. For example, on many of the properties, Taxpayer indicated that he met with contractors, supervised renovation and made repairs. However, the invoices for the property noted that Taxpayer’s nephew was actually the individual who performed such work.

In addition, for certain properties, Taxpayer conceded that he was not entitled to the claimed losses because they were not rental properties and therefore it was “irrelevant” whether he materially participated with respect to such properties. However, Taxpayer contended that the hours he spent on these properties counted toward the 750-hour requirement. The Court noted that Taxpayer was mistaken in his argument and deemed him to have waived any argument that he had materially participated in such properties and, consequently, would not count any of the hours spent on such properties toward the 750-hour requirement. Accordingly, the Court held in favor of the Service and concluded that Taxpayer was not a real estate professional.

Q. Hendrix v. Comm’r, T.C. Memo 2011-133. John and Carolyn Hendrix’s principal asset was JHHC stock. JHHC was incorporated in 1976 and subsequently became an S corporation. Around 1999, the Hendrixes informed their attorney that they wanted to give some of their JHHC stock to their daughters (through trusts) and to a charitable entity. Because of the difficulty in valuing the stock, their attorney suggested that they use a formula clause to define the stock transfer at the time of the gift in terms of dollars rather than in percentages, while fixing for Federal gift tax purposes the value of the transfer of the stock.

In preparation for their stock transfers, the Hendrixes retained an appraiser to estimate the value of the JHHC stock. In accordance with the appraiser’s estimate, the
Hendrixes decided that each of them would give $50,000 of JHHC stock to the charitable entity and would transfer approximately $15 million of JHHC stock to a generation-skipping tax ("GST") trust and an issue trust benefitting their daughters.

On December 31, 1999, the Hendrixes, the trustees and the charitable entity executed two sets of assignment agreements that irrevocably assigned approximately 400,000 shares of JHHC stock, in total, to the trusts and the charitable entity. Each agreement effected the transfer pursuant to a formula clause under which a portion of the 400,000 shares of JHHC stock having a fair market value as of the effective date equal to approximately $15 million was assigned to the GST trust and issue trust, with the remaining shares assigned to the charitable entity.

Approximately one month after the assignment, the Hendrixes asked the appraiser to appraise the value of the stock at the time of the assignment. The appraiser valued the JHHC stock as $36.66 per share. The appraisal was sent to the charity, which retained another independent appraisal firm to review the appraisal. That firm found the appraisal to be reasonable and fair. As a result, the charity and the trustees entered into confirmation agreements, effective as of December 31, 1999, that allocated among them the JHHC stock according to the fair market value of $36.66 per share listed in the appraisal.

The issue was whether the formula clauses were valid. The Hendrixes contended that the formula clauses were valid because the JHHC stock was hard to value and the clauses fixed the transferred amount. In addition, they believed that the parties to those clauses conducted themselves at arms'-length. The Service argued that the formula clauses were invalid because they were not reached at arms'-length and were contrary to public policy. The Service contended that the value of the stock was $48.60 per share, not $36.66 per share.

In making its decision, the Court stated that the burden of proof shifted to the Service inasmuch as the Service did not dispute the Hendrixes’ claim that the burden shifted to the Service under Section 7491(a) because they provided credible evidence.

The Court stated that *Succession of McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), a pro-taxpayer decision, generally was dispositive of the case except to the extent that the formula clauses were not the result of an arms'-length transaction or were void as contrary to public policy.

Regarding the arms'-length argument, the Court looked at prior case law and the evidence and concluded that the fact that the Hendrixes and their daughters were “close” and that the Hendrixes’ estate planning was beneficial to their daughters did not necessarily mean that the formula clauses were not arms'-length. Regarding the public policy argument, the Court held that the formula clauses did not “immediately and severely frustrate any national or State policy”. Instead, it viewed the formula clauses as one of encouraging gifts to charity and thus was in favor of the public. Accordingly, the Court determined that, consistent with *McCord*, the formula clauses controlled the value of the JHHC stock that was transferred to the trusts and the charitable entity and that the Service’s arguments were without merit.
R. Historic Boardwalk Hall, LLC v. Comm’r, 136 T.C. No. 1 (2011). New Jersey Sports and Exposition Authority (“NJSEA”) and Pitney Bowes formed Historic Boardwalk Hall, LLC (“Historic Boardwalk”) to allow Pitney Bowes to invest in the historic rehabilitation of a convention center in Atlantic City (the “Convention Center”). On its Federal income tax return, Historic Boardwalk allocated its qualified rehabilitation expenditures to Pitney Bowes, allowing Pitney Bowes to claim historic rehabilitation tax credits under Section 47. The Service issued Historic Boardwalk a notice of final partnership administrative adjustment (“FPAA”) claiming that Historic Boardwalk was a sham and that in substance the transaction was akin to NJSEA’s selling rehabilitation credits to Pitney Bowes.

As background, the Convention Center was erected in 1929. In 1992, the New Jersey State Legislature authorized NJSEA to renovate it. Rehabilitation of the structure began. To pay for a portion of the renovation costs, in 1999, NJSEA issued about $49.5 million of State Bonds and received approximately $22 million from the New Jersey Casino Reinvestment Development Authority. NJSEA also engaged the services of Sovereign Capital Resources, LLC to act as its financial adviser in finding an equity investor for the rehabilitation, which ultimately resulted in Pitney Bowes’ involvement.

In 2000, Historic Boardwalk was formed, whereby NJSEA was the managing member with a 0.1% membership interest and Pitney Bowes was the investor member with a 99.9% membership interest. Pitney Bowes made a capital contribution to Historic Boardwalk totaling $18,195,757 and made an investor loan of $1,218,000. Pitney Bowes’ capital contributions were used to pay down the principal on the acquisition note. Most of the time, after the capital contribution, a corresponding draw would be made on the construction note and the cash would be used to pay assorted fees related to the transaction and a $14 million developer fee to NJSEA. NJSEA and Pitney Bowes contemplated Pitney Bowes’ disposing of its membership and negotiated a number of exit strategies, including a put and call option. Pitney Bowes would receive a 3% annual preferred return either through a preferred net cash flow distribution (if Historic Boardwalk was profitable) or through a guaranteed investment contract on the exercise of its put option (if Historic Boardwalk was unprofitable).

The Service argued, among other items, that Historic Boardwalk lacked objective economic substance because Pitney Bowes would never earn a profit on its investment and any return in this transaction would be less than Pitney Bowes would have earned had it invested its capital contribution in other financial instruments. The Service did not take into account the 3% preferred return and the rehabilitation tax credits in its arguments. Relying on the fact that Congress enacted Section 47 in order to spur private investment in unprofitable historic rehabilitation and the fact that the transaction was structured to serve a legitimate business purpose (i.e., to allow Pitney Bowes to invest in the project, thereby creating more money for the rehabilitation), the Court concluded that Historic Boardwalk had an economic substance.

The Service also argued that Pitney Bowes was not a partner because its return was limited to 3%. Historic Boardwalk argued that, in accordance with Luna v. Comm’r, 42 T.C. 1067 (1964), the partnership agreement, the parties’ actions in negotiating the agreement, and the parties’ actions after the agreement was executed all indicated that they intended to join together to conduct an enterprise and that Pitney Bowes was a partner. The Court agreed with Historic Boardwalk. Ultimately, it held that all of the Service’s determinations in the FPAA
were incorrect. However, in light of the Fourth Circuit decision in Virginia Historic Tax Credit Fund 2001 LP v. Comm’r, 107 AFTR 2d 2011-1523 (4th Cir. 2011), it is unclear the weight to assign to this decision.

S. Estate of Jorgensen v. Comm’r, 107 AFTR 2d 2011-2069 (11th Cir. 2011). The Tax Court affirmed the Service’s position that certain transfers decedent had made to two family limited partnerships were to be included in the estate valuation because the decedent had retained the economic benefits and control of such property and that the transfers were not bona fide sales for full consideration. The Estate appealed to the Eleventh Circuit.

Although the Estate acknowledged that the decedent retained some benefits in the transferred property because she had written checks on partnership accounts to pay some personal expenses and to make some family gifts, it argued that these amounts should either be considered de minimis or Section 2036 should be limited to the actual amount accessed by the decedent.

With respect to the de minimis argument, because the decedent personally wrote over $90,000 in checks on the accounts post-transfer, and the partnerships paid over $200,000 of her personal estate taxes from partnership funds, the Court upheld the Tax Court’s decision.

With respect to the argument that Section 2036 should be limited to the actual amount accessed by the decedent, the Court upheld the Tax Court’s conclusion that there was an implied agreement that decedent could have accessed any amount of the “transferred” assets.

Finally, the Court upheld the Tax Court’s decision that the transfer was not a bona fide sale for adequate and full consideration. The Court focused on the facts that there were little non-tax justifications for the transfer and there was some disregard of partnership formalities.

T. Kaufman v. Comm’r, 136 T.C. No. 13 (2011). The Kaufmans owned a single-family row house located in a historic district of Boston. They entered into a preservation restriction agreement with the National Architectural Trust (“NAT”), under which they granted to NAT a façade easement. At the time of the contribution, the Kaufmans had a mortgage on the property. The primary issue in the case was whether the Kaufmans were allowed a charitable contribution related to the façade easement contribution under Section 170.

Section 170(h) and the underlying Regulations allow a charitable contribution for a façade easement if the restriction is granted in perpetuity. In this case, because the property had a mortgage and the bank had the first claim to all proceeds as a result of condemnation, casualty or the like, in 2010 (134 T.C. 182 (2010)), the Tax Court held that the façade easement contribution failed to satisfy the enforceability in perpetuity requirement and granted summary judgment in favor of the Service. The Kaufmanns asked that the Court reconsider its grant of summary judgment. The basis of this request was the fact that the preservation restriction agreement complied with the applicable Regulations. The Service argued that the preservation restriction agreement and the lender agreement had to be read together and that it is “insufficient for the agreements merely to parrot the regulations, and that, when read together, the agreements constitute[d] a conveyance that fail[ed] to conform to the extinguishment provision found in Section 1.170A-14(g)(6).” The Court agreed with the Service and reaffirmed the grant of summary judgment.

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Linton v. United States, 107 AFTR 2d 2011-565 (9th Cir. 2011). William Linton formed WLFB Investments, LLC (“WLFB”) on November 7, 2002. On January 22, 2003, Mr. Linton gave 50 percent of his interest in WLFB to his wife. On that same date, Mr. Linton executed a quit claim deed conveying undeveloped real property and letters authorizing transfers of securities to WLFB. In addition, on that same date, Mr. and Mrs. Linton and Mr. Linton’s brother executed a number of additional documents which they left undated, including four trust agreements (one for each of Mr. and Mrs. Linton’s four children) and documents gifting a percentage interest in WLFB to each of the four trusts. According to the attorney who prepared the documents, he mistakenly dated the trust agreements and documents relating to the gifts January 22, 2003 (the same date of the contribution of property by Mr. Linton to WLFB).

The LLC Agreement for WLFB placed restrictions on the transfer of percentage interests and limited the involvement of members in the day-to-day business of the LLC. In light of these provisions, in computing their gift taxes in 2003, the Lintons applied a 47% discount on their gift of WLFB interest to the four trusts. The Service contended that any discount was improper. The Lintons sought a partial refund of the gift taxes they paid for 2003.

In 2009, the District Court granted summary judgment for the Service. Because the trust and gifting documents were dated January 22, 2003, and because the Lintons offered no theory under which the trust agreements and gifting documents would have been rendered voidable had they never been dated, the Court held that the Lintons did not establish the existence of any genuine issue for trial. Relying on previous case law, the District Court held that the Lintons made indirect gifts of the assets they contributed to WLFB to the children’s trusts because the trusts were created and the gifts of LLC interests were made simultaneously with the contribution of property to WLFB.

The Ninth Circuit reversed the District Court’s grant of summary judgment in favor of the government and remanded to the District Court to determine whether the four elements of a gift under Washington state law were simultaneously present and when the Lintons first objectively manifested their intent to make the gifts effective.

V. Mayo Foundation for Medical Ed. & Research v. U.S., 107 AFTR 2d 2011-341 (S. Ct. 2011). In this Supreme Court Case, the Court affirmed the Eighth Circuit decision that the Treasury Department’s amendment to Reg. §31.3121(b)(10), which provided a full-time employee limitation on the FICA tax student exemption, was valid. The Court applied the two-part test set forth in Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), to determine that the Treasury Department’s full-time employee rule was a reasonable construction of Section 3121(b)(10). As a result, the wages of medical residents who work more than 40 hours a week are subject to FICA tax.

Interestingly, in this decision, the Court also settled the debate of which deference standard is utilized to determine the validity of Regulations promulgated by the Treasury Department under its general authority granted under Section 7805(a) where there is a notice and comment process; the less-deferential factor-based standard set forth in National Muffler Dealers Ass’n Inc. v. U.S. 440 U.S. 472 (1979) or the two-part standard set forth in Chevron. It concluded that Chevron provided the controlling deferential standard.
W. McNeil v. Comm’r, T.C. Memo 2011-109. Similar to Tempel v. Comm’r, 136 T.C. No. 15 (2011), the issue in this case was the characterization of the profits that arose from the sale of Colorado income tax credits relating to a conservation easement. The Court, relying on its decision in Tempel, concluded that the sale of the credits gave rise to short-term capital gain income. More specifically, the Court held that the “credits” were considered “capital assets” because they did not fall within any of the eight excluded categories set forth in Section 1221(a). In addition, the Court concluded that the holding period of the credit commenced at the time that the taxpayers received them, not when they acquired the real property that was the subject of the conservation easement.

X. Miller v. Comm’r, T.C. Memo 2011-189. In 1995, Jess Miller, through his revocable trust, owned all the stock of JAM Pharmaceutical, Inc. (“JAM”), a California corporation. Mr. Miller was the sole corporate officer and director of JAM from 1995 until 2007, when the company was dissolved.

JAM had made valid S corporation elections for 2002 and 2003. In August of 2002, JAM’s articles of incorporation were amended to authorize the issuance of two classes of stock: 1 million shares of Class A voting stock and 1 million shares of Class B non-voting stock. Thereafter, Mr. Miller surrendered his 10,000 shares of common stock for 10,000 shares of Class A stock (issued in two 5,000 certificates) and 90,000 shares of Class B Stock. In December of 2002, Mr. Miller and his son executed a purchase agreement, whereby Mr. Miller agreed to sell to his son 950,000 shares of JAM for $0.10 per share. The purchase agreement stated that his son was not obligated to purchase the shares until certain conditions were satisfied, including that Mr. Miller would deliver to his son his resignation as officer and director of JAM on the closing date. The closing date was not identified in the purchase agreement.

On December 31, 2002, Mr. Miller’s adjusted basis in his 100,000 shares of JAM stock was $866,795. He subsequently transferred 95,000 shares of stock (5,000 shares of Class A stock and 90,000 shares of Class B stock) to his son, who did not pay $95,000 for the shares. In addition, Mr. Miller did not resign as officer and director of JAM.

On his 2002 gift tax return, Mr. Miller reported the transfer of JAM stock to his as son as a gift subject to gift tax. He reported (1) the 5,000 shares of Class A stock, claiming his adjusted basis in the shares was $43,340 and the value of the gift as $34,600 and (2) the 90,000 shares of Class B stock, claiming his adjusted basis in the shares was $789,116 and the value of the gift as $511,200.

On its 2003 tax return, JAM first reported ordinary income of $355,152 and later amended its return and reported a loss of $1,110,390. On both the original and amended tax returns, JAM reported that Mr. Miller owned 5% of JAM’s stock.

On examination of the amended 2003 tax return in 2006, the Service determined that JAM had $382,452 of ordinary income for 2003 (of which $19,123 was Mr. Miller’s portion) and that Mr. Miller received distributions of $548,664 from JAM that exceeded his basis in the stock. In 2007, Mr. Miller’s son (as majority shareholder) accepted the Service’s adjustments to JAM’s income, among other items. In 2008, the Service sent Mr. Miller a notice of deficiency for 2003, claiming that his basis in the JAM stock was $51,661 after the transfer of
95% of his stock to his son, and therefore $548,664 in distributions from JAM to Mr. Miller were in excess of his stock basis and taxable as long-term capital gain.

The Service and Mr. Miller agreed that Mr. Miller’s stock basis was $866,795 before he transferred 95% of his shares to his son. However, they disagreed over Mr. Miller’s adjusted basis after the transfer. The Service calculated Mr. Miller’s basis by taking 5% of $866,795 (5% of his stock basis before the transfer) and adding his share of JAM’s ordinary income and interest for 2003.

At trial, Mr. Miller testified that he did not give his stock to his son in 2002. However, since his 2002 gift tax return and JAM’s stock certificate stubs identified December 31, 2002 as the date that 95,000 shares were transferred to his son, the Court did not give much weight to his testimony. Mr. Miller also argued that he sold part of the 95,000 shares to his son. However, since the purchase agreement terms were not satisfied (i.e., Mr. Miller never resigned as a corporate officer and director and his son did not receive 950,000 shares); Mr. Miller testified that his son did not pay the purchase identified in the purchase agreement; and Mr. Miller did not report a sale of JAM stock on his 2002 or 2003 tax return, the Court did not accept this argument. Finally, Mr. Miller contended that JAM made disproportionate distributions during 2003, which did not create a second class of stock, but instead should be “recharacterized” under Reg. §1.1361-1(l)(2)(j) to treat the effective date of the transfers of JAM stock to his son as occurring after the disproportionate distributions. The Court did not find that the Regulation supported Mr. Miller’s position and concluded that it was without merit. As a result, the Court agreed with the Service.

Y. 1982 East, LLC v. Comm’r, T.C. Memo 2011-84. In 2003, LLC purchased property in New York City and obtained a mortgage loan. The property was subject to New York City’s landmark and zoning laws and was in need of complete renovation. In 2003, LLC granted the National Architectural Trust (“NAT”) an easement restricting LLC from altering the property’s façade and from erecting any new or additional exterior improvement on the property in the open space above or surrounding the property, without the written consent of NAT. In 2004, LLC took out an additional mortgage loan to finance the renovation of the subject property. The mortgage lender was given the deed of easement and executed a lender agreement which stated that the bank was subordinating its rights in the property to NAT’s rights to enforce the conservation purposes of the donated property in perpetuity. However, the bank had a prior claim to all insurance proceeds as a result of any casualty, hazard or accident occurring to the property.

On its 2004 tax return, LLC claimed a charitable deduction equal to the $6,570,000 appraised value of the easement. The Service disallowed the entire deduction and asserted an underpayment penalty. The Service claimed that the donated property was not protected in perpetuity (as required under Section 170) by virtue of the bank’s mortgage on the property. Relying on the decision in Kaufman v. Comm’r, 134 T.C. 182 (2010) and Kaufman v. Comm’r, 136 T.C. No. 13 (2011) (where similar facts were presented and the Court held that the conveyance failed to satisfy the enforceability in perpetuity requirement), along with the legislative history of the perpetuity requirement in Section 170(h)(5)(A), the Court sided with the Service and held that the LLC’s contribution was not protected in perpetuity. In addition, the Court ruled that the donation did not satisfy the requirements of Section 170(h)(4) (requiring that
the contribution be exclusively for conservation purposes) because the local New York City law preserved the property and barred renovation without permission from the Landmark Preservation Commission.

The Court did not uphold the substantial underpayment penalty as the tax matters partner of the LLC made a reasonable attempt to comply with the Code. It based its decision on the fact that Kaufman dealt with a novel issue and was not published until more than 4 years after the filing of the tax returns at issue. In addition, the Court found that the tax matters partner acted in good faith by securing separate appraisals of the property and disclosing these appraisals on its tax return.

Z.  Estate of Palumbo v. U.S. 107 AFTR 2d 2011-1274 (D.C. Pa. 2011). In this case, the issue presented was whether the estate’s payment to a charitable trust, under terms of a settlement agreement, qualified as a charitable deduction under Section 2055. During his lifetime, Decedent created a charitable trust. In his Will (including 3 Codicils), he identified and defined the charitable trust, naming it as a “remainder beneficiary” in several places. However, due to a scrivener’s error, there was no express residuary provision in the Will. As a result of the lack of a residuary provision, Decedent’s son claimed that as the sole intestate heir, he alone was entitled to the residuary estate. The charitable trust contacted Decedent’s son and claimed that it was entitled to the residuary estate. The parties eventually entered into a settlement agreement, whereby the charitable trust received a portion of the residuary estate ($11,721,141) while Decedent’s son received $5,600,000 and real property. Subsequent to entering into the settlement agreement, the estate filed a claim for a Federal estate tax charitable deduction in the amount of $11,721,141. The Service disallowed the charitable deduction, claiming that it had been made by Decedent’s son via a settlement agreement, not by Decedent through his Will.

In making its determination, the Court reviewed the statutory construction of Section 2055 and discerned that a reason behind the change governing the tax law of charitable contribution was to “strengthen the incentive effect” of a charitable contributions deduction for taxpayers. In addition, it reviewed the case proffered by the Service which strictly construed Section 2056 and held that the narrow construction in that case was to curtail marital deduction abuses, which did not apply to this case. As a result, the Court held that it would not strictly construe Section 2055.

Then, the Court reviewed the Service’s argument that the charitable trust had no enforceable right to any portion of the residuary estate under Pennsylvania law, so that there was no bona fide dispute between the parties. In making its argument, the Service relied on Bach v. McGinnes, 14 AFTR 2d 6141 (3rd Cir. 1964), where the Court denied a charitable deduction. However, the Court found the facts in the Bach case differed from the facts of this case. In Bach, the surviving spouse elected to take against the will in order to ensure that there were funds available to be distributed to a university. In this case, the issue was not whether there would be any funds left to distribute to the charitable trust, but whether the charitable trust was considered a legatee.

The Service also argued that, under Pennsylvania law, the Court could not consider matters external to the Will in making its decision. Because the charitable trust had no legal right to the residuary estate, the Service stated that any sums that the charitable trust acquired
could not have been passed from the Decedent through his Will, and thus could not be considered a charitable deduction. However, the Court said that there was precedence for looking beyond “the four corners” of a will where there was ambiguity regarding a testator’s intent. In this case, the Court noted that all prior instruments contained provisions for the residuary estate to pass to the charitable trust and that the only reason the Will did not contain a residuary estate clause was due to scrivener's error. Consequently, the Court held that the Decedent did not intend to disinherit the charitable trust, and so the $11,721,141 should be deducted from the gross estate as a charitable donation under Section 2055.

AA. Estate of Petter v. Comm’r, 108 AFTR 2d 2011-5593 (9th Cir. 2011). Mrs. Petter inherited stock of UPS that was worth millions of dollars. She had two main estate planning goals - to provide for her children and grandchildren and to give money to charity. To accomplish these goals, Mrs. Petter created a family limited liability company. She transferred units of the family limited liability company to two defective grantor trusts for two of her three children. (The third child was disabled and was provided for separately.) In addition, Mrs. Petter gave units to two Section 501(c)(3) charities. To ensure that the trusts did not receive an amount that would cause Mrs. Petter to have to pay gift tax, a formula clause was designed so that the trusts would be given limited liability company units worth an amount that could be transferred free of gift tax and the excess units would be transferred to the charities. The initial number of units transferred to the trusts was based on a valuation of $536.20 per LLC unit; however, before the Tax Court, Mrs. Petter and the Service agreed that the final valuation was $744.74 per LLC unit. As a result, the number of units given to the charities and to the trusts changed.

The Service argued that Mrs. Petter gave a particular number of shares to her children and should be taxed on the basis of their now-agreed value. Alternatively, it argued that the formula clause was against public policy because it was using the charity to avoid tax. The Tax Court did not agree with the Service and held that Mrs. Petter’s gifts were based on an aggregate number of units to be divided at a later date based on appraised value, not a closed ended amount of units to each beneficiary. In addition, the Tax Court did not agree that the formula clause was against public policy, as there was no overarching public policy against these types of arrangements.

Moreover, the Tax Court allowed Mrs. Petter to claim a deduction for her gift of the additional units to the charities (resulting from the adjustment of the valuation price of each unit) as of the initial gift date (March 22, 2002). Even though the initial allocation of a particular number of units to the charities turned out to be incorrect, the Tax Court held that Mrs. Petter transferred a set number of shares as of March 22, 2002, and the subsequent reallocation of the units based on a change in the valuation of each unit did not change Mrs. Petter’s intention to create an immediately vested gift to the charities as of March 22, 2002.

The Service appealed the Tax Court’s decision, arguing that the adjustment feature of the defined-value clauses—requiring the trusts to transfer additional LLC units to the foundations, if the value of the units, as “finally determined for federal gift tax purposes,” exceeds a defined value—made the additional charitable gifts subject to the occurrence of a condition precedent. As a result, the Service claimed the charitable deduction arising from the
post-audit reallocation of units between the trusts and foundations were disallowed under Reg. §25.2522(c)-3(b)(1).

The Ninth Circuit did not believe that the dollar formula clause created a condition precedent. Instead, it held that the transfers were effective immediately upon the execution of the transfer documents and delivery of the units. Accordingly, the Court agreed with the Tax Court’s decision and held that Reg. §25.2522(c)-3(b)(1) did not bar a charitable deduction equal to the value of the additional units the charities would receive. At the end of its opinion, the Court invited the Treasury Department to amend its Regulations, if it was troubled by the Court’s resolution.

BB. Ramig v. Comm’r, T.C. Memo 2011-147. Ramig was an attorney and an entrepreneur. Along with others, he created an internet shoe company (“shoeS4Work”) in 2000. He owned common stock in shoeS4Work and was its CEO. Ramig made seven loans to shoeS4Work, of which four loans totaling $29,600 were never repaid. Ramig also personally paid approximately $11,000 of shoeS4Work’s operating expenses. ShoeS4Work stopped operation in 2002. Shortly before it shut down, one of its investors sued the company and Ramig for making misrepresentations to persuade her to invest in the company. Ramig paid approximately $13,000 in legal fees.

The first issue presented was whether Ramig was entitled to deduct the legal fees he incurred in defending the lawsuit as “ordinary and necessary business expenses” under Section 162. The Service argued that Ramig incurred the expenses to defend himself from a lawsuit and therefore the fees could not be deducted as a “business” expense. Because the Court found that the claim arose from misrepresentations of the company’s financial status while he was performing his duties as president and CEO, the Court held that the expenses were deductible under Section 162.

The second issue presented was whether Ramig was entitled to a bad debt deduction for the worthlessness of the debt owed to Ramig and other expenses he personally paid on behalf of the company. With respect to the debt, the Court examined whether the debt would be considered debt or an equity investment under the factors set out by the Ninth Circuit (to which the appeal of this case would lie), including the parties’ intent, the source of payment, the adequacy of the borrower’s capitalization, and the borrower’s ability to obtain loans from outside lenders. Because Ramig never requested interest payments nor showed concern about receiving such interest, took a subordinate position to other creditors, and only expected repayment if the company raised more capital, the Court held that the advances were equity investments, not loans. As a result, Ramig was not entitled to a bad debt deduction under Section 166.

With respect to the expenses personally paid by Ramig, Ramig offered no documents substantiating the agreement to repay, gave no evidence that similar loans were available from outside lenders and never demanded repayment. As a result, the Court held that such expenses were not bona fide debt and thus he was not entitled to a bad debt deduction.

In addition, the Court sustained the Service’s impositions of the accuracy-related penalty because it felt that Ramig acted negligently. He had an unlicensed bookkeeper prepare
his returns and made no effort to verify if the returns complied with the law. Also, he neither argued nor offered evidence that an exception excused him from the penalty.

CC. Rigas v. United States, 107 AFTR 2d 2011-2046 (D.C. Tex. 2011). Corporation purchased a portfolio of certain oil and gas interests and entered into a management agreement with Odyssey, a limited partnership. Under the management agreement, Odyssey would be paid a performance fee for its services. The fee was equal to 20% of the profits, after certain payments were made to Corporation. The performance fee was subject to a claw-back provision that ensured that Corporation would receive certain amounts.

In 2004, certain capital assets were sold and Odyssey received a performance fee of approximately $20 million. On its tax return, Odyssey treated the $20 million as net long-term capital gains. Mr. Rigas was a partner of Odyssey and filed his individual tax return in accordance with Odyssey’s tax treatment. The Service concluded that Odyssey’s profits interest was compensation for services, and so the income received by Mr. Rigas should be characterized as ordinary income. Mr. Rigas filed suit against the Service, and both parties moved for summary judgment on the partnership relationship between Odyssey and Corporation.

Mr. Rigas argued that Odyssey and Corporation were engaged in a joint venture/partnership, while the Service argued that they were engaged merely in a service relationship. Relying on Comm’r v. Culbertson, 337 U.S. 733 (1949) and Luna v. Comm’r, 42 T.C. 1067 (1964), the Court looked at whether the parties in good faith and with a business purpose intended to join together to conduct an enterprise. Because the management agreement explicitly disclaimed the existence of a partnership relationship and Odyssey did not possess an ownership interest in capital or assets of Corporation or the purported joint venture/partnership or a practical ability to control the assets, the Court granted summary judgment in favor of the Service. Even though Odyssey did share a profits interest with Corporation and the profits interest was subordinate to Corporation’s recovery of its expenses and initial investment, the Court felt that, in this case, these facts were consistent with the theory that Odyssey was a service provider to be rewarded with a percentage of the profits.

DD. Rodriguez v. Comm’r, T.C. Memo 2011-122. Conner, a CPA and guardian of the property of Rodriguez, a minor who was mentally and physically handicapped, arranged for Rodriguez’s parents to transfer title of their home to Conner in his individual capacity. Conner used Rodriguez’s funds to satisfy the mortgage on the home. Seven days after title was transferred to Conner, he executed a warranty deed in his individual capacity transferring the home to himself as guardian. That same day, Conner in his individual capacity as seller and in his capacity as guardian and buyer, executed a purchase and sale agreement. Conner prepared Rodriguez’s tax return and claimed the first-time homebuyer credit under Section 36. The issue was whether Rodriguez was entitled to the first-time homebuyer credit. The Service claimed that Rodriguez was not entitled to the first-time homebuyer credit under Section 36(c)(3) because he technically bought his home from related persons (his parents). Conner contended that he, as guardian, purchased the home from himself in his individual capacity, and thus Rodriguez did not purchase the home from a related person. The Court agreed with the Service and looked at the economic substance of the transaction over the form and held
that Conner was a mere "conduit through which to pass title" from Rodriguez’s parents to
Rodriguez.

executed an agreement which granted a façade easement to the Alabama Historical Commission.
The agreement stated that taxpayer granted the conservation easement in consideration for $10
and other good and valuable consideration. On taxpayer’s IRS Form 8283, “Noncash Charitable
Contributions”, he listed the appraised fair market value of the façade easement as $705,000.
The appraisal summary, attached to the IRS Form 8283, omitted various pieces of information
and did not attach a written appraisal of the façade easement. The Service issued taxpayer a
notice of deficiency disallowing the charitable deduction. Taxpayer petitioned the Court and the
Service sought summary judgment because taxpayer failed to obtain a contemporaneous written
acknowledgment of the façade easement from the Alabama Historical Commission as required
under Section 170(f)(8) and failed to substantiate the easement’s value.

Generally, under Section 170(f)(8), a charitable contribution of $250 or more must be
substantiated with a contemporaneous written acknowledgment from the donee organization.
The contemporaneous written acknowledgment must include: (1) the amount of cash or
description of the property contributed; (2) whether the donee organization provided any goods
or services in consideration for any property; and (3) a description and good faith estimate of the
goods or services provided by the donee organization. Taxpayer argued that the agreement
satisfied the acknowledgment requirements of Section 170(f)(8). However, the Service stated
that the agreement expressly stated that the Alabama Historical Commission provided
consideration for the façade easement of $10 “plus other good and valuable consideration,” and
the agreement failed to describe or provide a good faith estimate of the “other good and valuable
consideration”. Taxpayer argued that the language was typical “boilerplate” and should be
disregarded.

Although the Court recognized that the consideration may have been fictitious,
the Court concluded that, because the agreement failed to include a description and good faith
estimate of the “other good and valuable consideration”, the agreement failed to satisfy the
requirements of Section 170(f)(8)(B) and thus granted summary judgment in favor of the
Service.

Simmons owned two improved properties in Washington, DC, each of which was secured by a
mortgage. Ms. Simmons granted façade conservation easements on both parcels to L’Enfant
Trust, Inc. (“L’Enfant Trust”), a Section 501(c)(3) corporation. Each façade conservation
easement was memorialized by a “Conservation Easement Deed of Gift” (the “Deed”). The
Deed provided that Ms. Simmons could not make any material changes to the façade without the
consent of L’Enfant Trust, unless the façade was damaged. The Deed required that any work
done on the properties, whether L’Enfant Trust consented or not, was required to comply with all
Federal, state and local government regulations. Also, the Deed acknowledged that the
properties were encumbered by deeds of trust securing loans to a mortgage company, but that the
lenders agreed to subordinate their rights in the property to the rights of L’Enfant Trust and to
join in the execution of the Deed. Finally, the Deed provided that, if Ms. Simmons sold the
property, the easements would remain in force.
Ms. Simmons hired an appraiser, who valued the two façade easements at $255,500 and claimed a charitable contribution of such amount. The Service argued that the easements were not valid for purposes of Section 170 because L’Enfant Trust could consent to changes in the façades and because the easements were not granted in perpetuity inasmuch as they were subject to mortgages. The Tax Court disagreed with the Service’s arguments. Based on Reg. § 1.170A-14(d)(5), which provides that future development on a historic site will not jeopardize a Section 170 deduction if the development must conform with local, state or Federal standards, the Tax Court ruled that the easements were granted for conservation purposes under Section 170(h)(4)(A), even though L’Enfant Trust had certain consent rights. In addition, the Tax Court held that the perpetuity principle was met because the Deeds contained paragraphs explicitly indicating that the lenders subordinated their rights in the property to enforce the conservation purposes of the easement in perpetuity. However, the Tax Court held that the easements only had a fair market value of $98,500.

The Service appealed. It argued that the deeds failed to meet the “in perpetuity” requirement because: (1) each deed specifically stated that it should not be construed to limit L’Enfant Trust’s right to give its consent to changes in the façade or to abandon some or all of its rights and (2) neither deed contained a provision providing for the perpetuation of the easement in the event that L’Enfant Trust ceased to exist or abandoned its rights to enforce the easement. Ms. Simmons argued that both the District of Columbia’s historic preservation law and L’Enfant Trust’s interest in preserving its tax-exempt status would prevent L’Enfant Trust from abandoning the easements or approving changes inconsistent with the conservation purposes of the easements. If L’Enfant Trust were dissolved, Ms. Simmons stated that the State Historic Preservation Officer testified that the easements would be transferred to another organization engaged in similar activities. The Court agreed with Ms. Simmons and held that it would not change the Tax Court’s decision based upon the remote possibility that L’Enfant Trust would abandon the easements. The Service also tried to argue that the appraisal was not qualified because the appraiser failed to explain the “method of valuation” he used and to include a substantive basis for the valuation, but the Court held that the Tax Court did not clearly err in concluding that the appraisal satisfied the necessary requirements.

GG. Tempel v. Comm’r, 136 T.C. No. 15 (2011). In 2004, the Tempels donated a qualified conservation easement on approximately 54 acres of their land located in Colorado to the Greenlands Reserve. The Tempels incurred $11,574.74 of expenses in connection with their donation. In addition to claiming a deduction for the fair market value of their donation, the Tempels received $260,000 of conservation income tax credits from Colorado. The Tempels sold $110,000 of their State tax credits to unrelated third parties for $82,500 and gave away $10,000 of their credits. The Tempels reported $77,603 of short-term capital gains from the sale of their State tax credits. This amount was calculated by subtracting half of the expenses paid in connection with their donation from the total proceeds they received upon the sale of the credits ($82,500 minus ($11,574.74 x .50)). In 2008, the Service issued the Tempels a notice of deficiency claiming that they did not have any basis in the State tax credits and that the gains were ordinary, rather than capital, in nature. The Tempels petitioned the Tax Court and both parties moved for partial summary judgment.

The Tax Court held that the gains were capital in nature, but that the Tempels did not have any basis in the tax credits. With respect to the nature of the gains, the Court reviewed
the Service’s arguments; specifically whether the transfer of credits represented a right to receive income. The Court concluded that there was no support for the Service’s proposition and viewed that credits as analogous to a government’s decision to tax one taxpayer at a lower rate than another, which is not considered “an accession to wealth” to the taxpayer with a lesser tax detriment. With respect to the determination of basis in the tax credits, the Court focused on the fact that Section 1012 defines cost basis as what a taxpayer paid to acquire an asset and the Tempels did not acquire the State tax credits by purchase.

HH. Estate of Van v. Comm’r, T.C. Memo 2011-22. The issue of this case was whether Ms. Van retained possession or enjoyment of a house in California that she lived in until she died, even if title was not solely in her name. More specifically, in 1973, Ms. Van’s suitor, Mr. Marcel Periat, bought the house for her and paid all the expenses related to the house. About 15 years later, Ms. Van’s daughter and her husband (the “Hus”) wished to purchase the house, but Mr. Periat would not sell the house to them. Instead, Mr. Periat sold the house to Ms. Van, who used the Hus’ money to pay for the house. Title passed to Ms. Van; however, within a few hours of recording the deed, she conveyed title to the house to herself and her daughter’s children, as joint tenants. About 5 years later, Ms. Van had her two grandchildren convey title to the house back to her. Then, about 3 years later, Ms. Van created a revocable trust and deeded the house to herself as trustee. Two years later, she transferred title to the house from herself as trustee to her daughter’s three children. All of the transfers were gratuitous.

The Estate made two arguments. First, it argued that the Hus were the real owner and Ms. Van had only taken title as their agent. However, because Ms. Van took legal title to the house and actually lived there, the Court found that Ms. Van had acquired a beneficial interest during her lifetime. Second, it argued that, because the Hus supplied the purchase money, they had a beneficial interest in the house, resulting from California law’s resulting trust doctrine. However, because the resulting trust doctrine arises where the transferee was not intended to take the beneficial interest in the property, the Court found that this doctrine was inapplicable in this situation, even though the Hus paid for the property.

The Estate also tried to argue that, even if Ms. Van had a beneficial interest in the house, her divestment of title acted to remove the house from the value of her estate. The Court did not find this argument viable under the facts presented herein. As a result, the Court concluded that Ms. Van had a beneficial interest in the house and displayed a sufficient degree of possession or enjoyment under Section 2036 to be included in her taxable estate.

II. Virginia Historic Tax Credit Fund 2001 LP v. Comm’r, 107 AFTR 2d 2011-1523 (4th Cir. 2011). Many states have enacted legislation designed to encourage investment in historic properties. Virginia provides such an incentive in the form of a Virginia tax credit. Because the amount of the historic tax credits issued to a developer may exceed its income tax liability, some states allow credits to be sold or transferred; Virginia is not such a state. However, Virginia does have a partnership allocation provision which allows partners to allocate tax credits “as the partners … mutually agree”.

In this case, three taxpayers jointly set up certain partnership funds to take advantage of the historic tax credit program. The funds began soliciting investors who were willing to contribute capital to the partnership in exchange for the allocation of state tax credits.
A fund would become a limited partner in selected historic property development partnerships and would provide capital contributions in exchange for tax credits. The funds did not invest in the historic property development partnerships until the projects were completed.

On their tax returns, the funds reported the money paid to the historic property development partnership as a partnership expense and reported the investors’ contributions as nontaxable contributions to capital. On audit, the Service challenged the characterization of the investors’ “contributions to capital” and concluded that the investors were not actual partners of the funds and instead were purchasers of the state income tax credits. As a result, the Service believed that the funds should have reported the money they received from the investors as income.

The Tax Court rejected the Service’s assertions and concluded that the investors were partners for Federal tax purposes under the test set forth in Comm’r v. Culbertson, 337 U.S. 733 (1949). The Service appealed. The Fourth Circuit began its analysis by looking at Reg. §1.707-3, which sets forth a presumption that, where a partner contributes property to a partnership and receives a distribution within two years, then the transfer is considered a sale. In this case, the Court concluded that the exchange of tax credits for investor contributions was presumed to be a sale because the transfers occurred within two years of one another. This presumption could only be overcome by finding that the facts clearly established that the transfer did not constitute a sale. Regulation §1.707-3(b) sets forth ten factors to consider, such as whether the partner’s right to receive the transfer of money was secured and whether the transfer of money by the partnership to the partner was disproportionately large in relation to the partner’s general and continuing interest in partnership profits. Believing that the investors had no real entrepreneurial risk because they were promised a fixed rate of return, rather than any share of partnership profits, the Court reversed the Tax Court and held in favor of the Service.

JJ. Watson, PC v. United States, 105 AFTR 2d 2010-2624 (D.C. Iowa 2010). David Watson, a certified public accountant, along with others, formed LWBE, an accounting firm, in 1992. In 1996, Watson replaced his individual ownership in LWBE with ownership by a professional corporation (“PC”), which elected to be taxed as an S corporation. On that same date, Watson, LWBE and PC entered into an employment agreement whereby Watson became PC’s employee and agreed to provide his accounting services exclusively to LWBE. At a shareholder meeting of PC (Watson was the sole shareholder) in 2000-2002, Watson authorized for himself a salary of $24,000, which PC did, in fact, pay to Watson in 2002 and 2003. In 2002 and in 2003, in addition to his salary, Watson received checks from PC totaling over $200,000. In 2007, the Service assessed approximately $48,000 in taxes, penalties and interest against PC for 2002 and 2003 because it determined that portions of the dividend distribution from PC to Watson should be characterized as wages, subject to employment taxes. PC paid $4,063.93 towards the assessment and filed a claim of refund, which was denied by the Service. Thereafter, PC filed this action claiming that the Service improperly recharacterized the dividend as wages and requested that the Court order summary judgment in favor of PC.

In its summary judgment motion, PC contended that it was the intent of PC that controlled whether funds paid to Watson were characterized as wages or as dividends. To support its position, it relied on several cases, including Pediatric Surgical Associates, P.C. v. Comm’r, T.C. Memo 2001-81. However, the Court stated that in those cases the Taxpayer was
trying to recharacterize the funds, whereas in this case the Service was trying to recharacterize the funds. Moreover, the Court found that PC’s position was further undermined by Revenue Rulings and applicable case law which held that neither the election by the corporation or consent of the stockholders had any effect in determining whether payments were “wages” for employment tax purposes. As a result, the Court denied PC’s request for summary judgment because it felt that there needed to be a factual inquiry into whether the funds were remuneration of services.

KK.  **WB Acquisition, Inc. & Subsidiary v. Comm’r, T.C. Memo 2011-36.** In this case, the issue was whether a joint venture between related parties constituted a partnership. B and W, individuals, were employees of Corporation A and owned all of Corporation A’s stock. They sold the stock to an unrelated-third party, REXX. B and W remained employees of Corporation A, even when it was owned by REXX. Due to some financial difficulties encountered by REXX, B and W repurchased Corporation A’s stock. Corporation A entered into a redevelopment project with the City of San Diego, but B and W were concerned that creditors from other projects might be able to reach the cash flow from the San Diego redevelopment project. Consequently, they formed a joint venture agreement between Corporation A and WB Partners, a partnership that indirectly owned all the stock of Corporation A. The joint venture agreement provided that 30% of the San Diego redevelopment project’s profits would be allocated to Corporation A and the remaining 70% would be allocated to WB Partners.

For purposes of determining whether the joint venture was legitimate, the Court analyzed whether a partnership existed under the factors set in **Luna v. Comm’r,** 42. T.C. 1067 (1964) and **Comm’r v. Tower,** 327 U.S. 280 (1946), such as the conduct of the parties, the parties’ control over income and capital, whether business was conducted in the name of parties, and whether separate books were maintained. Although there was a written agreement, the Court focused on several instances where the joint venturers acted outside “the plain language of the agreement”, most notably when they decided to cap the amount allocated to WB Partners when the San Diego redevelopment project became more profitable than expected. This resulted in WB Partners having a 50.4% interest in the profits instead of a 70% interest. In addition, the joint venture did not file a Federal income tax return. The Court analyzed all of the eight factors set forth in **Luna** and concluded that five factors weighed against finding a joint venture and three were neutral. As a result, it held that Corporation A and WB Partners did not intend to join together in the conduct of a joint venture.

LL.  **Wheeler v. Comm’r, T.C. Summ. Op. 2011-83.** In February of 2003, Taxpayer lived with Adam Beeman in a home located in Massachusetts which was previously purchased by Mr. Beeman. Taxpayer paid Mr. Beeman rent in an amount equal to one-half of the mortgage payments. In 2004, Mr. Beeman decided to return to school, and Taxpayer and Mr. Beeman agreed that Taxpayer would assume more responsibility of the mortgage. In 2006, Mr. Beeman and Taxpayer had a child together and decided that Mr. Beeman would become a stay-at-home parent. As a result, Taxpayer continued to be the primary provider for payment of the family’s expenses, including the mortgage and improvements made to the property.

Before 2007, Taxpayer considered all amounts she contributed to the mortgage to be “rent”. However, in 2007, Taxpayer and Mr. Beeman agreed orally that Taxpayer should have property rights in the home because of her contributions to the mortgage payments. On
June 13, 2007, Taxpayer’s name was added to the mortgage and placed on the deed to the home. On her tax return, Taxpayer claimed a home mortgage interest deduction of approximately $16,000. The Service allowed a deduction of approximately $6,000 based on the fact that Taxpayer did not acquire title to the home until June.

In order to determine if Taxpayer was entitled to the home interest deduction for all of 2007, the Court examined whether Taxpayer was a legal or equitable owner as of January, 2007. With respect to legal ownership, the Court stated that under Massachusetts law, the statute of frauds generally requires that contracts for the purchase and sale of real property be in writing. Because Taxpayer and Mr. Beeman only had an oral agreement and Taxpayer failed to provide evidence that they reached an agreement on significant issues (such as the purchase price and type of ownership interest involved), the Court concluded that Taxpayer did not have a legal ownership interest in the property before June 13, 2007. With respect to equitable ownership, Taxpayer argued that, by paying a portion of the mortgage payments throughout the first half of 2007 and paying for improvements to the home, she gained equitable ownership in the property on January 1, 2007. However, the Court found that under Massachusetts law, even if a purchase agreement is reached, a transferor of an ownership interest in real property retains the legal title to the property until payment of the purchase money price. Thus, because Taxpayer did not have a written agreement to purchase the property in January of 2007, Taxpayer was not an equitable owner at that time. The Court also briefly examined several factors used to determine whether a taxpayer is an equitable or beneficial owner of property, including whether the taxpayer had the right to possess the property and to enjoy the use, rents, or profits thereof; borne the risk of loss; and had the right to obtain legal title at any time by paying the balance of the purchase price. The Court stated that several of these factors weighed against Taxpayer for the period before her addition to the mortgage. Consequently, it held that Taxpayer was not an equitable owner as of January 2007 and sustained the Service’s determination.